

QUARTERLY REPORT ON THE SPANISH ECONOMY

1 Overview

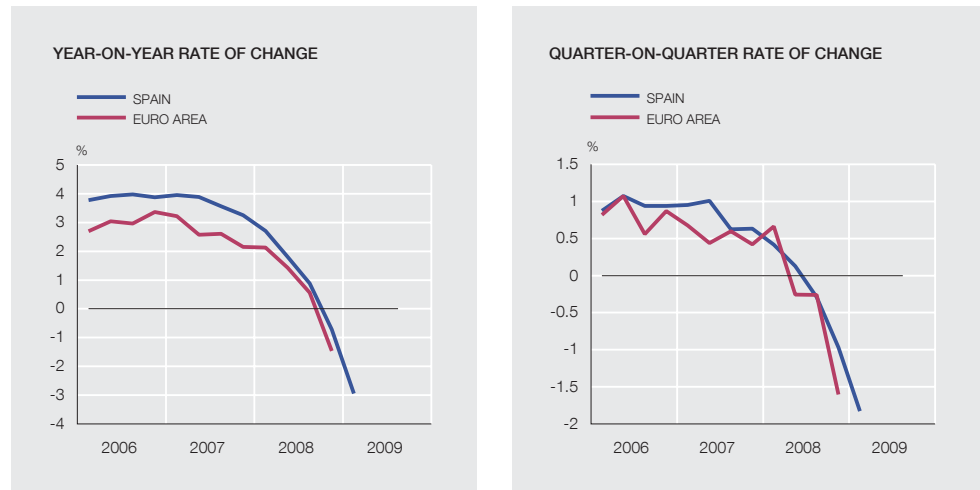
There was a continual loss of momentum in the Spanish economy in 2008 which stepped up in the second half of the year, leading to a decline in the year-on-year rate of GDP of 0.7% in Q4. Behind this is the forceful decline in national demand, which fell by 2.8% in Q4, while there was a positive contribution of net external demand to GDP growth of 2.3 pp in the same period, derived above all from the rapid loss of steam in imports.

The indicators available for the opening months of 2009 point to an intensification of the contractionary trends observed in late 2008, in a severely recession-bound international environment in which the degree of financial strain has remained high. Estimates made drawing on the as yet incomplete economic information available suggest a more pronounced decline in activity in Q1, meaning that the year-on-year rate of GDP is expected to have declined by 2.9% (-1.8% in quarter-on-quarter terms). On the expenditure side, it is estimated there has been a further reduction in national demand, whose annual rate would fall by 2 pp to -4.9%, and a slight fall in the contribution of net external demand, to 2.2 pp, a reflection of the sharp contraction in world trade. On the supply side, the contractionary trajectory of the construction and industry branches seen in late 2008 intensified, while services began to show signs of stagnating, owing to the decline in market services. Against this background, employment figures were most adverse in Q1, with a decline in employment of 6.4%, according to EPA figures, which has led to a substantial rise in the unemployment rate to 17.4% (13.9% in Q4). As a consequence of the sharp turnaround in oil and food prices, and to the market weakness of demand, the inflation rate declined markedly during the quarter, posting a negative year-on-year rate of change – for the first time since 1952 – of -0.1% in March, and a likewise negative inflation differential with the euro area of -0.7 pp (see Box 1).

On the international economic front, the strains on financial markets showed some improvement relative to the height of the instability experienced in the closing months of 2008, although financing conditions remained globally tight. In the circumstances the pass-through of the financial crisis to activity continued, exacerbated in the recent period by the sharp decline in trade flows. As a result, GDP in the developed economies is expected to have fallen back further in Q1, on a scale similar to that seen in late 2008, on a par with the increasing weakness in the emerging economies. Globally, inflation slowed markedly, posting negative annual rates in a growing number of countries, against a backdrop in which commodities prices stabilised, although oil prices rose somewhat.

Overall, all these factors have made for a fresh downward revision in the growth outlook for the world economy. On the latest forecasts, which are subject in any event to a high measure of uncertainty, growth could turn negative in 2009 for the first time in the last 60 years. That would delay the start of the recovery until 2010, when all the effects of the stimulus provided by monetary and fiscal policy and by the support to the financial system should have worked through. In this recessionary scenario, price projections point to very moderate growth in the inflation rate, which might post negative figures in some of the main developed economies in 2009, such as the United States and Japan.

Over the course of the quarter, the economic authorities continued to act with resolve to check the deterioration in the economic and financial situation globally. In this respect, further macroeconomic stimulus and financial system support measures were announced, while an important



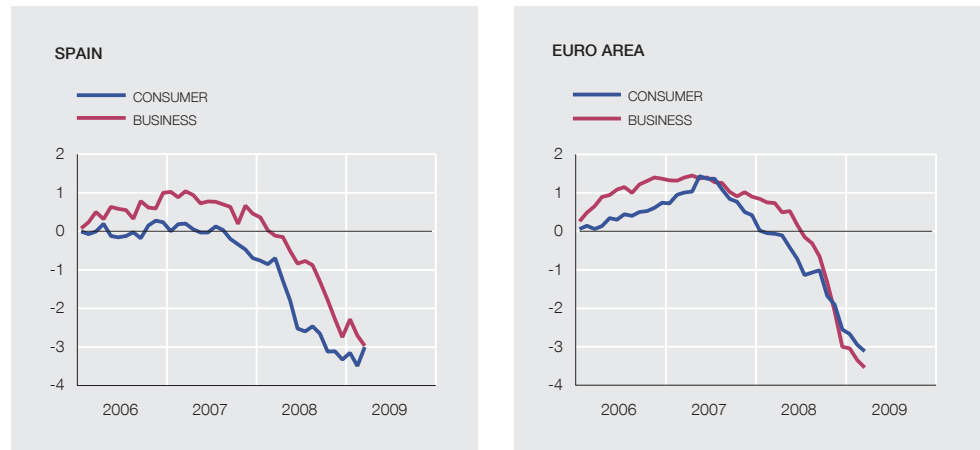
SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

commitment was reached at the London G20 meeting on 2 April to reinforce the international financial framework. Among the fiscal stimulus plans, the new US administration approved a package in March for an amount equivalent to 5% of GDP, while the Japanese authorities announced a raft of fiscal measures for an amount of 3% of GDP. As to financial system restructuring plans, the US Treasury set in train a new financial stabilisation programme in March which includes the possibility of fresh capital injections, credit support measures and government financing of private sector-managed funds to acquire troubled assets.

Central banks, meantime, maintained a supply of unlimited liquidity and further cut official interest rates. In instances in which the room for further cuts was already limited, exceptional monetary policy operations were undertaken (basically comprising the purchase of private and public assets), which required changes to be made to the operational framework of the central banks in question. In this connection, the Federal Reserve held its federal funds target rate in a range of 0 to 0.25% (its December level), but began to make government debt purchases in order to influence the long-term segments of the yield curve. The Bank of England left Bank rate unchanged, after having cut it in January to 0.5%, and also launched a government bond purchase programme. The ECB Governing Council decided to continue providing a large volume of funds with an unlimited supply of liquidity at fixed rates, and maintained its mechanisms for the provision of liquidity in dollars. In addition, it cut its key rates on three occasions, following the January, March and April meetings, meaning the reduction since October has amounted to 300 bp, with the rate on its main refinancing operations at 1.25%. Regarding the possibility of increasing monetary policy instruments, the President of the ECB said that the Council would consider the possibility of adopting new extraordinary monetary policy measures at its first meeting in May.

This set of measures has checked the deterioration in the main indicators of financial strains, with signs of improvement discernible, more clearly so since March. Interbank market interest rates continued to decline, although they remain considerably above the rates on secured bank loans, denoting the persistence of strains. Risk premia in the credit derivative markets eased somewhat and, on the equity markets, share prices posted increases in March and April that partly offset the heavy falls in January and February. Meanwhile, the implied volatility indices declined significantly. At the time of this Bulletin going to press, share prices were still at



SOURCE: European Commission.

a. Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).

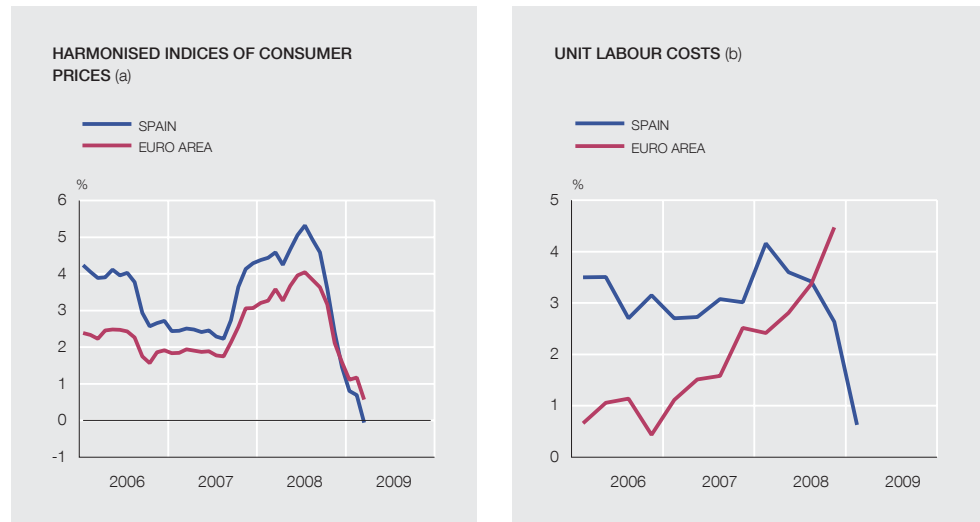
lower levels than at end-2008 on most stock markets. Turning to government debt markets, yields fell in the shorter-dated terms but increased in the longer-dated ones.

Activity in the world economy continued to worsen following the very negative GDP growth figures in Q4 in the United States, the United Kingdom, Japan and the euro area. There was a strong slowdown in the emerging economies, more markedly so in the new EU Member States that do not belong to the euro area (see Box 2), as a result of the adverse impact of the financial crisis on credit conditions.

In the euro area, the available economic indicators point to a significant worsening of activity in the opening months of 2009 owing to the tightening of financing conditions, the fall in confidence and the effects of the strong decline in world trade. Inflation continued to fall, reaching a level of 0.6% in March, an all-time low since the creation of the euro area. This was the result of baseline effects in respect of energy prices and, to a lesser extent, of the sluggishness of domestic demand.

Further to these developments the external environment of the Spanish economy has become strongly contractionary and financing conditions remain restrictive. Although the cost of bank lending to households and firms fell significantly, compared with end-2008 levels, financial institutions once again tightened their lending standards, albeit to a significantly lesser extent than in the preceding quarters. The negative trajectory of stock market prices during the quarter, which compounded the heavy losses accumulated in 2008, and the intensification of the falling trend of property prices – which were down 6.8% year-on-year in Q1, according to the information provided by the Ministry of Housing – led to fresh declines in the value of private-sector wealth.

The contractionary course of household spending seen in the closing months of 2008 continued into 2009. Household consumption fell by 3.3% year-on-year in 2009 Q1, constrained by the strong slowdown in disposable income, a reflection above all of the sharp deterioration in employment. Other, counteracting factors were unable to offset this powerful effect. These factors included those that helped underpin household purchasing power during the quarter, such as the expansionary general government measures, the decline in inflation and the fall in interest payments borne by households, which are beginning to attest to the decline in inter-



SOURCES: Eurostat, ECB and INE.

a. Year-on-year rate of change.

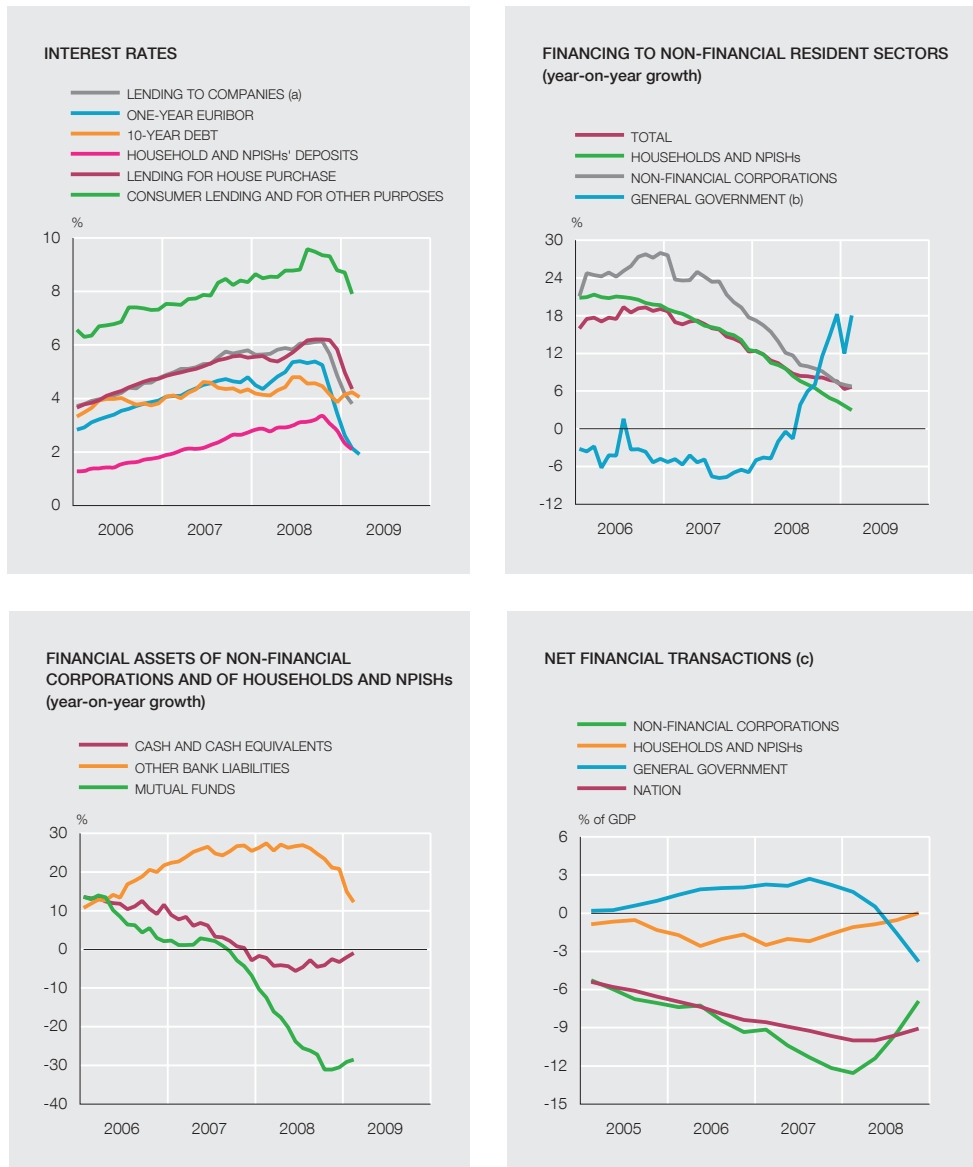
b. Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

bank rates, even though several quarters must elapse before the effects feed through fully to disposable income. In addition, household wealth contracted and confidence remained very depressed in the face of the worsening general macroeconomic outlook, which contributed to households drawing in their spending plans, beyond what the slowdown in disposable income might justify. All these factors, along with the need to reduce the debt built up in recent years, are proving conducive to a rapid recovery in the saving ratio, which climbed to 13% of disposable income in 2008, almost 3 pp up on the previous year.

Residential investment weakened further, affected by the revised expectations concerning property values – in view of the decline seen in house prices and doubts about their future course – and by tighter financing conditions. A decline of over 20% is estimated for the year-on-year rate of this variable. The pace of the correction in real estate supply has also quickened in past months, pressured by the build-up of a high number of unsold properties, which has continued to increase over recent months.

The downscaling of household spending plans, along with stricter lending standards, meant that the decline in the annual pace of household financing continued in Q1, falling to 3% in February. That shows the lower growth observed in lending for house purchase (which stood at 3% year-on-year in February) and in lending for consumption and other purposes (2%). However, the seasonally adjusted quarter-on-quarter rates point to less dynamism in these variables which, in some cases, may be expected to translate into negative growth rates. The slowdown in household debt allowed for the continuing reduction in their debt ratio, albeit still moderately.

The fall-off in business investment steepened in Q1, in line with the sluggishness of both domestic and external demand, the climate of uncertainty and the persistence of rather unfavourable financing conditions for undertaking investment projects. As in the case of households, the standards applied by banks for the approval of new loans became stricter, more markedly so for small and medium-sized enterprises, in line with the greater risk such transactions entail. Moreover, the resort to internal financing sources was hampered by the decline in share prices



SOURCE: Banco de España.

a. Weighted average of interest rates on various transactions grouped according to their volume. For loans exceeding €1 million, the interest rate is obtained by adding to the NDER (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.

b. Consolidated financing: net of securities and loans that are general government assets.

c. Four-quarter cumulated data.

and by the downward revision of earnings expectations. Investment in capital goods fell by around 20% year-on-year, and investment in other construction, which includes investment in non-residential construction and the participation of private-sector companies in civil engineering works, prolonged the declining trajectory that had begun the previous quarter. It is nonetheless expected that, following the start-up of the work to be undertaken under the State Fund for Local Investment, this domestic demand component will regain some momentum from April.

Set against the fall-off in investment and the tighter supply of bank funds, borrowing by non-financial corporations continued to slow, reaching a year-on-year rate of slightly below 7% in February, which made for a moderate reduction in their debt ratio. As with households, the

attendant quarter-on-quarter growth rates reveal a less buoyant performance. The latest information on credit by end-use, for December 2008, shows a widespread slowdown across the branches of activity, although this is sharpest in construction and real estate services, posting negative rates of 1% in the former case.

Weaker domestic spending was alleviated by net external demand to a lesser extent than had been habitual in previous quarters, owing to the growing role that the trade channel is playing, in Spain too, in spreading the global crisis (see Box 3, which analyses recent euro area export developments). Exports saw a greater reduction in intensity than in 2008 Q4, in step with the abrupt collapse in international trade in the most recent period and the contraction in economic activity in our main trading partners. Imports, meanwhile, underwent a further fall. As regards tourist services, the indicators available also point to negative figures in Q1, which are accentuating the rapid deterioration that came about in the closing months of 2008, further to the heightening of the international financial crisis. Against this background of worldwide activity grinding to a halt, the decline in non-tourist services, which comprise activities such as communications, transport and financial services, was likewise on a very large scale. Overall, the sharp reduction in global trade flows has tended to dilute the potential support for exports arising from the improved relative behaviour of the price-competitiveness indices in recent months.

The January Balance of Payments figures show a notable correction – of almost 40% in year-on-year terms – in the Spanish economy's net borrowing, the result of the reduction in the trade deficit and, to a lesser extent, of the deficits on the income and transfers accounts. This trajectory will foreseeably continue in the coming months, in line with the narrowing of the trade deficit observed in February.

On the supply side there were declines in Q1 in the value added of all productive branches in the market economy. In the case of services, this was the first time a fall had come about since this phase of cyclical adjustment began. In any event, the contraction in activity was most substantial in the construction sector, where there have been declines in value added for five consecutive quarters, and in industry, following the sudden collapse observed in the closing months of 2008. Job destruction in the market economy became more acute, with a contraction in employment that affected all the productive branches, especially construction and industry. The ratio of temporary to permanent employees fell to 25.4%. Overall, the rate of decline in employment was higher than that in value added, whereby there was a fresh increase in productivity.

Labour costs turned down to some extent in Q1, chiefly reflecting the effect of the correction of inflation in the final quarter of 2008. The improved price performance favourably affected inflation expectations, which helped provide for wage settlements (2.7% to March) that were lower than in 2008 (3.6%), although they remain high if the marked weakness of the labour market is taken into account. A further factor containing labour costs is the fact that the wage indexation clauses will have no effect this year, since the growth rate of the CPI at end-2008 did not exceed 2%. It is therefore estimated that compensation per employee in the market economy will stand at around 3% in Q1 (close to 4% for the whole economy) and that the rate of change of unit labour costs will be temporarily reduced owing to the countercyclical nature of productivity in Spain.

Inflation declined markedly in Q1 as a result of which the rate of change of the CPI was negative in March (-0.1%) for the first time since 1952. One determinant of this sharp slowdown has been the pronounced decline in energy prices compared with a year earlier; but, additionally, the reduction in inflation has been extensive to all the less volatile components and, most

Inflation in Spain – proxied by the rate of change of the consumer price index (CPI) – has slowed substantially since the summer of 2008, when it peaked at 5.3% in July, to -0.1% in March 2009, the lowest rate of change since 1952. Since December 2008, moreover, this growth rate has been considerably below that for the euro area. Most analysts consider that, temporarily, negative rates of change will continue to be posted in the coming months. That is prompting a debate on the scale of this disinflation episode and also on the possibility that the Spanish economy may move into a deflationary spiral.

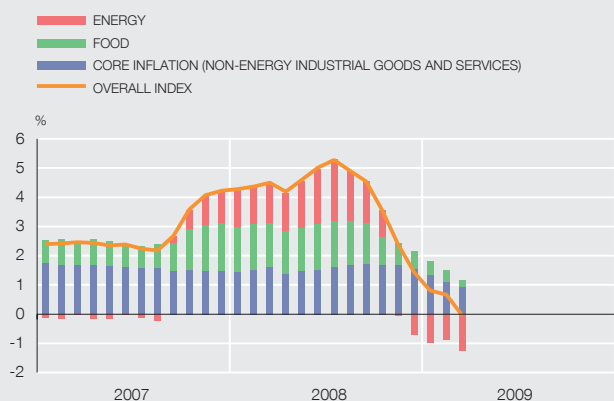
Although it is a widely held misconception, deflation should not be confused with the mere fact that the rate of change of a price index is temporarily negative. Reductions in the prices of goods and services, especially in a moderate inflation environment, come about habitually. The adjustments in relative prices driven by supply and demand shocks are necessary for the efficient allocation of economic resources and do not entail a deflation process. From a rigorous analytical perspective, the concept of deflation only applies to the phenomenon of a widespread and sustained decline in prices in an economy.

It should further be borne in mind that price level falls may be caused by shocks of a different nature. Hence positive supply-side shocks

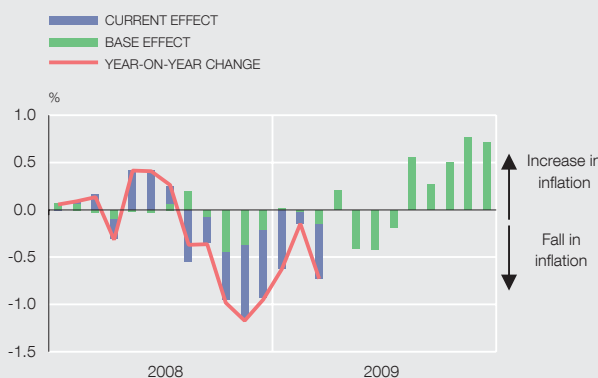
that improve productivity may lead to widespread declines in prices, but they are in this case accompanied by higher growth in output and by increases in workers' real wages and in corporate profits. Conversely, the process may prove damaging if it is in response to a sharp contraction in demand capable of triggering expectations of sustained reductions in prices that inhibit consumption and investment decisions, refuelling downward pressures on spending and on prices themselves. The severity of such a situation is exacerbated by the increase in the real value of debts and by higher debt-servicing payments in real terms, thereby posing greater difficulties for indebted households and firms. And given that this occurs in a setting in which nominal interest rates cannot be negative, monetary policy effectiveness is substantially curtailed.

It should be stressed that deflationary spirals are eminently monetary phenomena. Accordingly, in a monetary union they cannot arise in isolation only in certain countries but will affect the entire area. Such spirals are therefore intimately linked to monetary policy, which is set for the whole area and steers inflation expectations in the countries included in the zone. The sole risks of deflation in Spain, therefore, are those that may exist for the whole of the euro area. And these, according to the analysis of the European Central Bank's Governing Council, are remote.

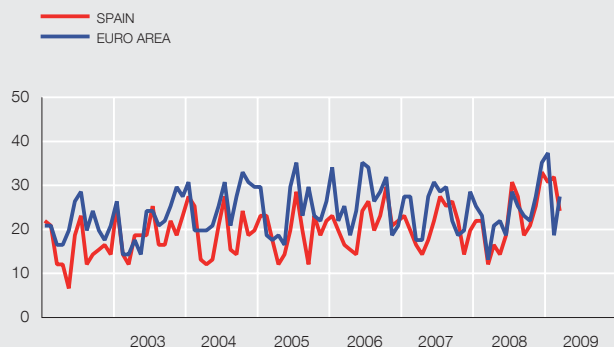
1 CONTRIBUTIONS TO THE YEAR-ON-YEAR RATE OF THE CPI



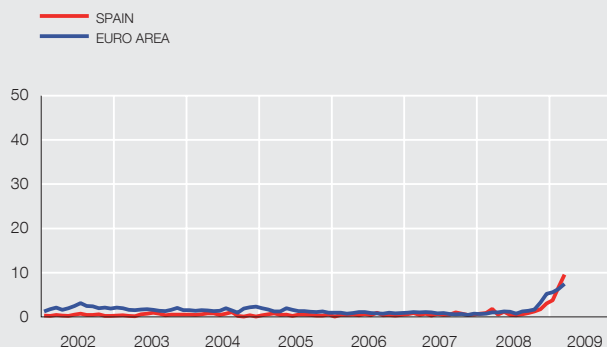
2 CHANGE IN THE YEAR-ON-YEAR RATE IN RELATION TO THE PREVIOUS MONTH



3 DIFFUSION INDICATORS OF DECLINES IN PRICES
Percentage of items of the HICP with declines in prices



4 EXPECTATIONS OF DECLINES IN PRICES OVER THE NEXT TWELVE MONTHS
European Commission Business and Consumer Survey



SOURCES: INE, Eurostat, European Commission and Banco de España.

Within a monetary union there may be divergences in the rates of increase of prices across the different economies, as has been the case with Spain since the start of EMU. But these differences are confined since, when they exceed certain limits, the cumulative real appreciation or depreciation of the country's exchange rate tends to give rise to a correction. In this respect, the Spanish economy's inflation differential with the euro area between 1999 and 2008 has entailed an appreciation of the real exchange rate and an erosion of price competitiveness, with adverse consequences for production and employment generation, the correction of which is manifest both in the contraction in demand and in the existence, for the first time, of a negative price differential. This affords a competitive advantage which, if maintained, will be conducive to greater export dynamism and a recovery based on a more sustainable pattern. However, to preserve this gain once the recession is behind us, reforms that increase competition in certain markets and lead to improved productivity across the productive branches will be needed.

To characterise the reduction in inflation and the episode of falling prices in Spain appropriately, an accounting exercise has been performed which breaks down the year-on-year growth of the CPI in terms of its main components. This shows that the decline in the year-on-year rate of the CPI between July 2008 and March 2009 largely responds to the course of the most volatile components (see panel 1). The change in the CPI rate has also been broken down into two terms. The first relates to the month to which the rate refers (current effect), and the second to the performance in the same month of the previous year (based effect), the aim being to discern the influence of past and present phenomena on the behaviour of year-on-year rates (see panel 2). According to this analysis, the simple statistical effect might lead to a 1 pp cut in the year-on-year rate of change of the CPI between May and July 2009, owing essentially to the rise in oil prices which occurred in the related months in 2008. Likewise, the notable fall in oil prices in the second half of 2008 would exert upward pressure on the year-on-year growth of prices in the second half of this year, offsetting the previous downward trend, meaning that the CPI may be expected to post positive rates of change in the closing months of 2009.

In this respect, the observed decline in inflation largely responds to the trend of the more variable components of the CPI, which are those that account for the negative rates being recorded mid-year and which give these rates their temporary nature. Yet this

should not mask the falls in non-energy industrial goods prices and the substantial reduction in services inflation, which reflect greater sensitivity to developments in demand and are propitious to improved competitiveness. The recent trajectory reveals a considerably greater adjustment in the prices and margins of these products than that which might be derived from past experience, and has enabled the growth differential of Spanish prices with those of the euro area to turn negative, even for these core inflation goods.

To ascertain how generalised the declines in prices are, a diffusion indicator has been constructed for Spain and the euro area that measures the percentage of items¹ of the harmonised index of consumer prices (HICP) whose month-on-month rate is negative. The indicator shows that the declines in prices of certain products are not infrequent, in line with the microeconomic evidence available (see panel 3). These price reductions generally affect those articles that most benefit from technological innovation, such as computers and electronic products. It can likewise be seen that the current recession is prompting a somewhat greater generalisation of price reductions both in Spain and in the euro area, although the percentage of items affected is still small in both cases.

Finally, a very important aspect of the potential scope of the falls in prices is the behaviour of expectations. An indicator of price expectations can be obtained from the European Commission's monthly Business and Consumer Survey. Specifically, one of the questions to respondents is: "By comparison with the past 12 months, how do you expect that consumer prices will develop in the next 12 months?" . It is a multiple-choice question, with one of the replies being that prices will fall. Panel 4 shows that the percentage of households expecting a fall in prices is historically close to zero both in Spain and in the euro area, although in recent months there has been some increase in both economies. In any event, in 2009 the proportion of Spanish households expecting a decline in prices within one year is only 10%, and somewhat below this figure in the euro area as a whole. This behaviour of expectations is consistent with the temporary nature attributed to the current negative inflation rates and appears to denote a very limited influence of price reductions on the potential deferral of consumption and investment decisions.

¹ The 91 items available in the most detailed breakdown of the HICP have been used in the construction of this indicator.

particularly, to services prices, which have historically shown scant cyclical sensitivity. It is estimated that the ongoing recession is prompting a far greater adjustment in services prices and margins than past experience would indicate, and is enabling Spain's price growth differential with the euro area to turn negative, to which the greater effect of oil fluctuations on Spanish prices is also contributing.

Foreseeably, the CPI will continue to post negative rates of change in the coming months. But this will be a temporary development since it arises from the statistical effect linked to dearer oil in early 2008. Accordingly, it should not be inferred that the Spanish economy is going to face a situation of widespread price declines or that it is close to moving into a deflationary spiral. As analysed in some detail in Box 1, in a monetary union, deflationary spirals are eminently monetary phenomena which affect the single currency across the board, and which do not arise in isolation in only certain parts of the monetary area. Against this backdrop, the fact that a negative price differential with the euro area is in place for the first time affords something of a competitive advantage which should be preserved, once the period of sluggish demand has been put behind, by means of reforms that increase competition in certain markets and lead to improved productivity across the productive branches.

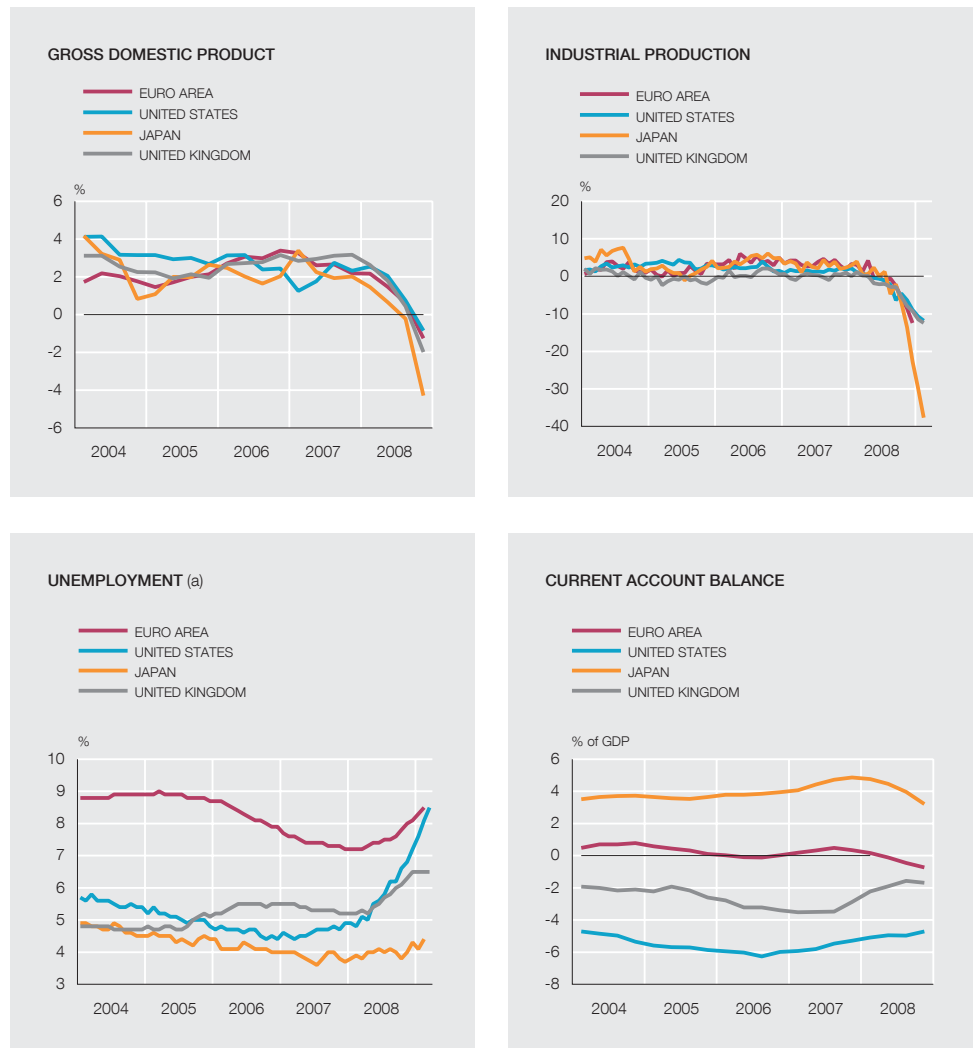
A general government deficit of 3.8% of GDP was recorded at end-2008. That was 6 pp worse than the previous year and gives some idea of the forceful impact the recession has had on public finances, although it is also a consequence of the discretionary measures adopted to soften the effects of the crisis on demand. As a result, the European Council summit decided Spain's deficit was excessive and recommended reducing this deficit by 2012 at the latest. A further deterioration in public finances is expected in 2010, with both the budget deficit and the public debt ratio rising in 2009, even in the absence of new discretionary measures of an expansionary nature. That underscores the scant headroom available to continue using budgetary policy as an instrument for boosting demand, and highlights the importance of the budgetary consolidation plans to resume a path of stability in the medium term.

2 The external environment of the euro area

Since March, the international financial markets have shown some incipient signs of recovery, after months marked by heavy losses and bouts of instability. The sharp and continued macroeconomic deterioration, which points to a 2009 Q1 as negative as 2008 Q4, and the difficulties in the banking sector were largely offset by the announcement and subsequent implementation of macroeconomic stimulus and financial industry support measures and by a series of better-than-expected corporate earnings releases from some of the US financial institutions. New financial industry support measures were announced throughout the quarter, some of them company-specific, such as the additional aid packages for Citigroup or AIG, and some more general. Most notable among the more general measures are, in the United States, the Treasury's new Financial Stability Plan which allows for new capital injections, credit support measures such as extension of the Federal Reserve's TALF facility and the creation of private-sector funds for acquiring problem assets with public-sector funding and, in the United Kingdom, the release of further details on the Treasury's Asset Protection Scheme (APS) for problem asset portfolios held at financial institutions. The central banks, for their part, announced new monetary policy measures and some countries whose official interest rates are already very low – such as the United Kingdom and the United States – started to purchase public debt instruments, aiming to stabilise long-term interest rates. Several previously-announced fiscal stimulus programmes were implemented in the quarter and various new ones were announced. The scope of these programmes varies enormously, according to each country's implementation capacity, the strength of their automatic stabilisers and the perceived effectiveness and sustainability of the measures.

In this setting, the credit and interbank markets improved gradually, while the equity markets posted gains in many countries, with a significant decrease in volatility. The foreign exchange markets were quite stable, two developments worthy of note being the gradual yen depreciation in the quarter and appreciation of the emerging currencies against the dollar. Despite government bond purchases by the Federal Reserve and the Bank of England, there was no significant fall in long-term interest rates; in fact, in the United States, they rose slightly due to the increase in public-sector net borrowing. The emerging markets, similarly to the developed markets, performed favourably in the quarter, especially in March: emerging market bourses recorded even larger gains than those seen in other economies, and sovereign credit spreads narrowed virtually across the board. However, the situation of the most vulnerable economies that had been hardest hit in the previous months, such as the eastern European economies (see Box 2), remains difficult. On the commodities markets, the price of Brent oil rose in the quarter from \$40-45/barrel in January to over \$50 at the end of March, as lower demand was offset by a drop in production by the OPEC countries. Food prices showed little change in the quarter, but metals prices rose, driven by demand from specific countries (for example, demand for copper from China).

In the United States, the final GDP estimate for 2008 Q4 confirmed a decline of 6.3%, far steeper than the 0.5% fall in Q3. Thus for the year as a whole, GDP growth stood at 1.1%, 0.9 pp lower than in 2007. The higher-frequency indicators are again showing sharp signs of contraction in recent months, despite some indications of growing stability in the housing market and in private consumption. On the demand side, consumer confidence indices remained at all-time lows, although the underlying component of retail sales improved somewhat in the quarter (despite the decline in March). A number of housing market indicators, such as house sales, housing starts and construction permits, rebounded in Q1, although they fell

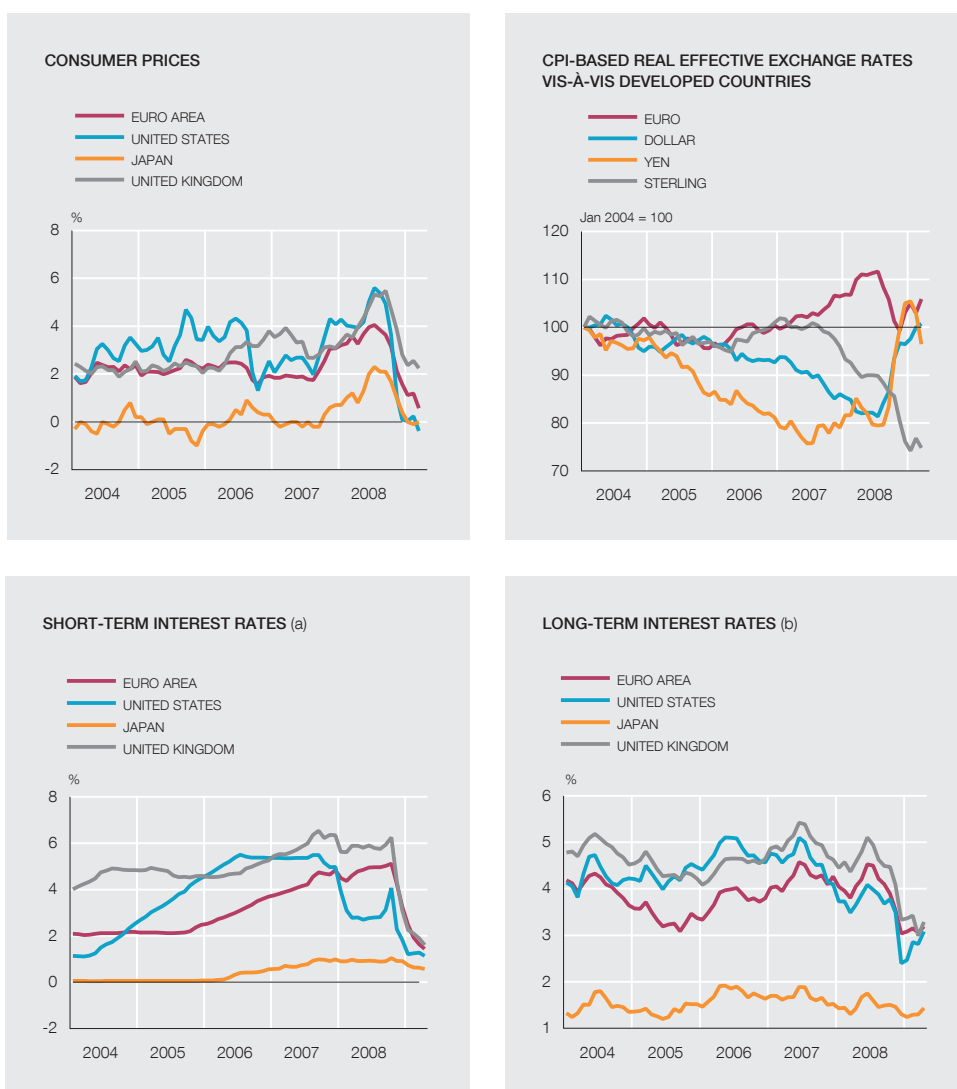


SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

back again in March. House prices continued to drop sharply year-on-year and, in 2008 Q4, mortgage foreclosures and default rates continued to rise. Activity indicators remained weak in the quarter, with the manufacturing and non-manufacturing PMIs at record lows and industrial production down sharply. The labour market witnessed large-scale job destruction, with a net loss of two million jobs in the quarter, taking the unemployment rate up from 7.2% at the end of 2008 to 8.5%. The inflation rate entered negative territory in March, going from 0.2% to -0.4%, while core inflation held at 1.8%. In this setting, the Federal Reserve held its target federal funds rate within the range of 0% to 0.25%. At the same time, it made further changes in its monetary policy strategy, including, inter alia, the public debt purchases mentioned earlier. The Treasury, for its part, secured approval for a \$787 bn fiscal stimulus package (5.5% of GDP) targeting tax cuts, financial aid – in particular for the health system and the individual States – and increased public expenditure.

In Japan, Q4 GDP – despite being revised up slightly – shrank by 12.7% in annualised quarter-on-quarter terms, a much larger drop than that seen in the other developed economies. In 2008 overall, GDP fell by 0.6%, against growth of 2.4% in 2007. Moreover, the



SOURCE: Banco de España.

- a. Three-month interbank market interest rates.
 b. Ten-year government debt yields.

bulk of the most recent indicators remain very unfavourable, despite some signs that the deterioration is losing pace. Thus the February manufacturing and services PMIs remained very weak, despite a minor increase, the Q1 Tankan survey pointed to a collapse in business confidence and industrial production continued very negative in year-on-year terms (-9.4% in February) in the light of excessive inventories. Consumer indicators, such as retail sales, also continued to deteriorate, down more than 5% year-on-year, due inter alia to the rising unemployment rate and nominal wage contraction. There was a current account deficit in January and February, for the first time since 1996, due to the sharp fall in exports. Turning to prices, average inflation measured by the CPI fell by 0.1 pp in February to -0.1%. The Bank of Japan held its official interest rate unchanged in March at 0.1% and the government announced a new fiscal stimulus package worth 5.4 bn yen (3% of GDP).

In the United Kingdom, the preliminary 2009 Q1 GDP estimate showed further contraction: -7.7% in annualised quarter-on-quarter terms, against -6.1% in the previous quarter. The

RESPONSES

The global economic and financial crisis has severely impacted the emerging economies, but the effect is being felt in particular by many of the new EU Member States¹, as a result of their severe macroeconomic and financial imbalances. It was precisely their entry into the European Union that drove the convergence process, backed up by large-scale foreign capital inflows. In this setting, credit expanded rapidly, much of it denominated in foreign currency, and this contributed hugely to domestic demand growth. But there has been a downside to this strong expansion, in the form of the persistently high current account deficits and the consequent dependence on external borrowing. This dependence is particularly marked in the banking sector, where EU banks have a considerable presence². Accordingly, many of these countries have, from a financial point of view, become highly vulnerable to a reversal of the favourable economic climate such as that witnessed in recent quarters (see Table 1 which depicts the main vulnerability indicators for the new EU Member States, together with their monetary policy strategies).

The heightened financial tension seen in the first few months of 2009 accentuated international investors' aversion to this group of countries far more than to other emerging regions, as is shown by the growth in credit default swaps (CDSs) (see Panels 1 and 2). The countries that are most dependent on external borrowing and that have most exposure to foreign currency credit – the Baltic States, Hungary, Bulgaria and Romania – have been hardest hit by the financial markets.

Fears of credit quality deterioration led to large-scale capital outflows from the region, severe credit restrictions and strong pressure for currency depreciation. These pressures were realised in the countries with floating exchange rates, whilst in those with fixed exchange rates there were considerable strains on interest rates and reserves diminished. The sharp economic slowdown in the rest of the European Union was already being felt by the economies of the region, most of which are very open, in terms of external demand, but the latest deterioration in the financial climate and the heightening of the economic difficulties in Europe exacerbated the adjustment in the fourth quarter, establishing a feedback loop between the two areas. In fact in recent months all the main international organisations and private institutions have cut back their growth forecasts for the region for 2009, more so than for other emerging economies. The latest IMF WEO report forecasts that GDP among the new EU Member States will shrink by 2.9% in 2009, almost double the decline expected for the economies of Latin America, whilst the emerging Asian economies (including China) are expected to post 3.3% growth.

The high net external borrowing of the new EU Member States, and their limited capacity to meet these funding requirements domestically, suggest that substantial internal adjustments will be needed, together with considerable external support, to help these econo-

mies ride out the crisis. In this respect, the support capacity has increased significantly in recent months³.

In these circumstances, and as a response to the crisis, the region's governments have gradually adopted a series of measures to support the banking sector, including extending bank deposit guarantees and, in some cases, recapitalisations and bank debt guarantees. These measures have had to be supplemented and reinforced with access to external support.

In light of the liquidity problems stemming from the strains on the international financial markets, a number of countries have asked for help from other central banks: Poland and Hungary, in the form of repo transactions totalling €10 bn and €5 bn, respectively, from the ECB, and euro/Swiss franc swap facilities from the Swiss central bank; Latvia, in the form of euro/lats swap facilities totalling €500 m from the central banks of Sweden and Denmark.

In addition, some countries with more pressing net external financing requirements have also had to ask for financial assistance – conditional upon fiscal adjustment and financial sector restructuring programmes – via lending facilities organised jointly by the IMF, the European Union, the World Bank, the development banks and neighbouring countries. To date, three countries have benefited from this assistance (see breakdown in Panel 2): Hungary (€20 bn), Latvia (€7.5 bn) and most recently Romania (€20 bn) at the end of March. The credit lines made available to these three countries by the IMF are in the form of a general Stand-by Arrangement (SBA) conditional upon fulfilment of the terms set out in the support arrangement. For its part, on 14 April Poland applied for \$20.5 bn, equivalent to 1,000% of its quota, under the new Flexible Credit Line (FCL) which implies no conditions ex post but rather verification ex ante that prudent policies have been implemented and that economic fundamentals are sound, with a view to shoring up its economic position and as a preventive measure. The European Union has granted its lending facilities through the Medium-Term Financial Assistance (MTFA) scheme set up for this purpose, with €35.4 bn still available for further contingencies.

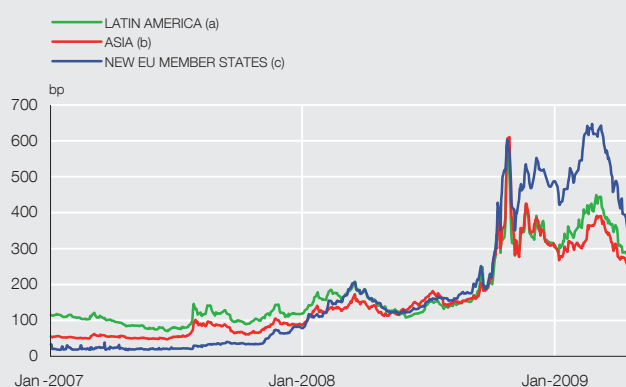
In short, against the backdrop of the global crisis, the combination of large external and internal imbalances and banking sector financial vulnerability have placed the new EU Member States in a particularly difficult position and one that will require considerable effort and economic adjustment. These countries will need to adopt firm economic policy commitments and to make progress in their structural reforms, to correct their current macroeconomic and financial imbalances. In this respect, the coordinated multilateral financial aid packages received by some of these countries and the related economic measures may constitute a starting point from which to redirect the present situation and find a way out of the crisis.

3. The EU envisages aid for these countries, directed at solving their balance of payment difficulties, in the form of Medium-Term Financial Assistance (MTFA) which has been doubled to up to €50 bn. In addition, the IMF, which has raised its funding capacity to \$750 bn, the development banks and other multilateral financial bodies constitute another important pillar; specifically, the EBRD, the EIB and the World Bank have approved an injection of funds into the region totalling €24.5 bn until 2010. This external support is in addition to the more specific support measures provided by the neighbouring countries and by the European central banks, including the ECB.

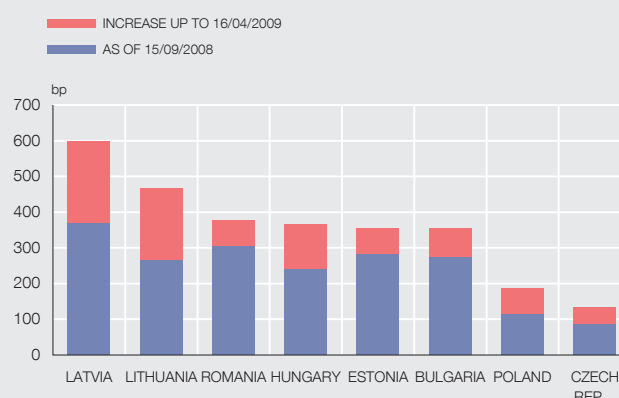
1. The new EU Member States to which we refer are all those that have not yet joined the euro area and that became EU members in May 2004 (the Czech Republic, Poland, Hungary, Estonia, Latvia and Lithuania) and January 2007 (Bulgaria and Romania). 2. See E. Gordo and A. del Río (2009), "Las relaciones comerciales y financieras de la UEM con Europa central y del este", *Boletín Económico*, March, Banco de España, pp. 92-103.

RESPONSES (cont'd)

1 CDSs IN EMERGING REGIONS



2 CDSs IN NEW EU MEMBER STATES



3. VULNERABILITY OF THE NEW EU MEMBER STATES (d)

		LATVIA	ESTONIA	LITHUANIA	BULGARIA	ROMANIA	HUNGARY	POLAND	CZECH REP.
MONETARY POLICY STRATEGY									
Exchange rate regime		Fixed rate ($\pm 1\%$)	Currency board	Currency board	Currency board	Floating	Floating	Floating	Floating
Entry in ERM		Yes May-2005	Yes June-2004	Yes June-2004	No	No	No	No	No
Target		Exchange rate	Exchange rate	Exchange rate	Exchange rate	Inflation	Inflation	Inflation	Inflation
VULNERABILITY INDICATORS									
Real GDP (% y-o-y)	2008 (Q4)	-10.5	-9.7	-2.0	3.6	2.9	-2.3	2.9	0.7
	2009 (e)	-12.0	-10.0	-10.0	-2.0	-4.1	-3.3	-0.7	-3.5
GDP per capita in PPP (EU-27 = 100)	2008	55.2	64.2	60.5	39.7	44.8	61.6	55.1	83.0
HICP inflation (% y-o-y)	Mar-09	7.9	2.5	7.4	4.0	6.7	2.8	4.0	1.7
Current account balance (% of GDP)	2008 (f)	-14.0	-10.5	-12.4	-22.7	-12.7	-5.7	-3.7	-1.4
FDI (% of GDP)	2008 (f)	4.7	5.5	2.5	18.0	6.3	1.7	2.8	4.9
Gross external debt (% of GDP)	2008 (f)	124.4	108.5	67.7	93.1	n.a.	114.0	46.5	39.5
Reserves/Short-term external debt (%)	2008 (f)	38.5	39.3	82.2	107.7	n.a.	103.1	121.6	129.4
Private sector credit (% y-o-y)	2003-2008	44.7	31.0	45.3	43.4	55.1	20.3	16.7	15.9
	2009 (Jan)	11.0	6.0	16.0	30.0	34.1	23.0	36.0	15.0
Cross-border loans (% of GDP)	2008 (f)	63.7	56.9	35.7	31.5	24.5	33.1	13.7	16.6
S&P CREDIT RATING									
Foreign currency debt (LT/ST)		BB+/B	A/A-1	BBB/A-3	BBB/A-3	BB+/B	BBB-/A-3	A-/A-2	A/A-1
Outlook		negative	negative	negative	negative	negative	negative	stable	stable

4 INTERNATIONAL FINANCIAL SUPPORT FOR THE NEW EU MEMBER STATES (g)

	DATE OF AGREEMENT	IMF	EU	WORLD BANK	OTHERS (h)	TOTAL
Hungary	October 2008	12.5	6.5	1.0	—	20.0
(% of total)		62.5%	32.5%	5.0%	—	
Latvia	December 2008	1.7	3.1	0.4	2.3	7.5
(% of total)		22.7%	41.3%	5.3%	30.7%	
Romania	March 2009 (i)	13.0	5.0	1.0	1.0	20.0
(% of total)		64.9%	25.1%	5.0%	5.0%	
Poland	Applied April 2009 (j)	20.5				20.5

SOURCES: Datastream, BIS, ECB, IMF, European Commission, Eurostat and Standard & Poors.

a. Brazil, Chile, Mexico, Colombia and Peru.

b. Malaysia, Indonesia, Hong Kong, China, India and Korea.

c. Poland, Czech Republic, Hungary, Bulgaria, Romania, Estonia, Latvia and Lithuania.

d. The highlighted figures represent high levels of vulnerability.

e. IMF forecasts (WEO, April 2009).

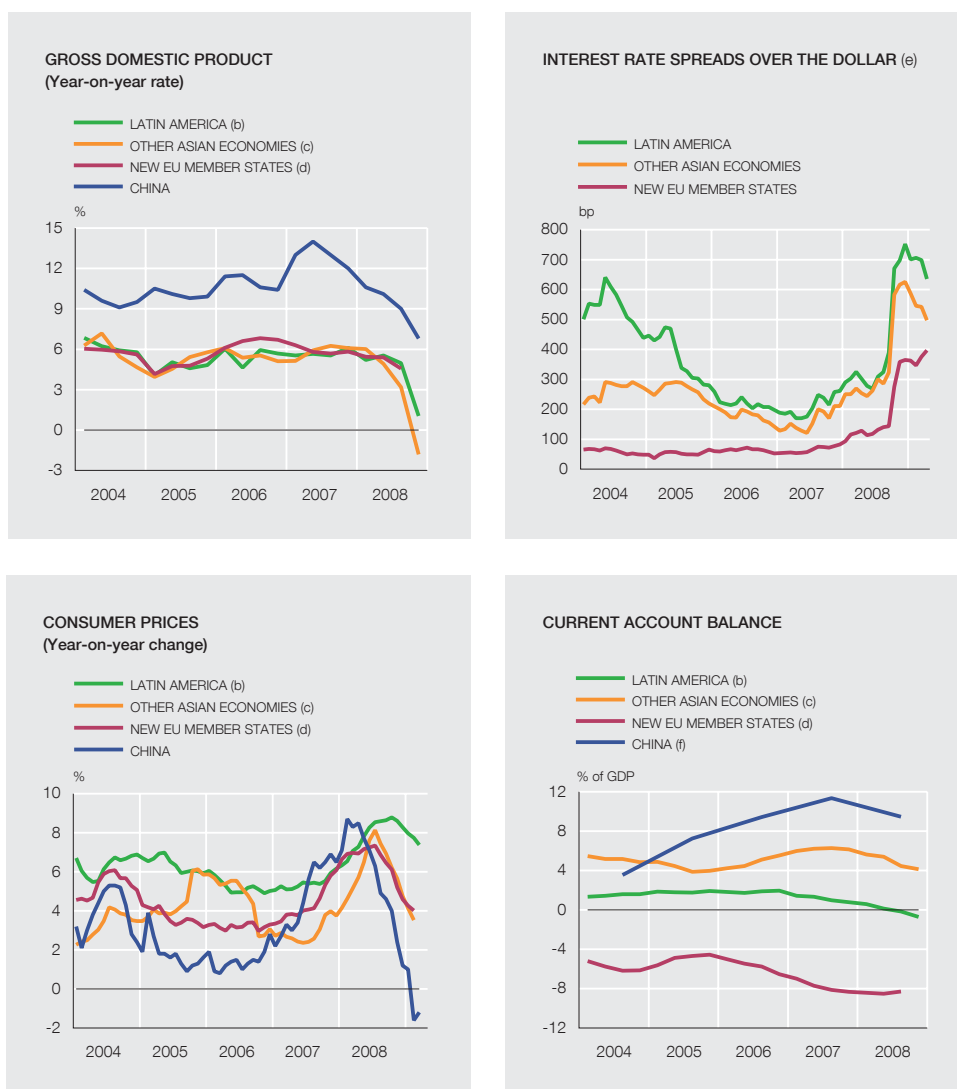
f. Moving average of the last four quarters, up to 2008 Q3.

g. Figures in €bn, except for Poland in \$bn.

h. In Latvia, €1.8 bn corresponds to funds received from Sweden, Denmark, Finland and Norway, and €500 m to the Czech Republic, Poland, Estonia and the EBRD. In Romania, the EBRD participates together with other multilateral organisations.

i. Pending ratification in May.

j. Pending approval by the Board of the IMF.



SOURCES: National statistics and JP Morgan.

- a. The aggregate of the different areas has been calculated using the weight of the countries that make up these areas in the world economy, drawing on IMF information.
- b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
- c. Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore, Philippines and Taiwan.
- d. Poland, Hungary, Czech Republic, Estonia, Latvia, Lithuania, Bulgaria and Romania.
- e. JP Morgan EMBI spreads. The data on the new EU Member States relate to Hungary and Poland. The aggregate for Asia does not include China.
- f. Annual data.

majority of the most recent indicators continued to reflect a downturn, especially in the case of manufacturing industry. The correction also continued in the property market, despite an improvement in some indicators, and the decline in house prices seemed to stabilise in March around 16% year-on-year. Bank lending slowed again in Q1, with further tightening of credit conditions, the labour market deteriorated sharply (unemployment rose to 6.7% in February) and confidence remained at all-time lows. Nevertheless, signs of a possible easing in economic deterioration are beginning to emerge: the PMI indices improved significantly in March and according to the Bank of England's latest Credit Conditions Survey, credit institutions expect to offer more mortgage and corporate credit – although not consumer credit – in Q2. In this respect, under the Asset Protection Scheme (APS), the participating institutions have undertaken to increase the supply of credit available. Turning to prices, inflation fell by 0.3 pp to

2.9% in March and the Bank of England expects it to go below the 2% target in the second half of the year. At the April meeting, it held Bank rate unchanged at 0.5%; it also said it would continue with its quantitative easing strategy via asset, especially government debt, acquisitions. The fiscal budget for 2009 envisages a deficit of 12.4% of GDP; it includes no new stimulus packages, due to the limited room for manoeuvre in light of the significant increase in government debt.

In the new EU Member States that do not belong to the euro area, GDP decelerated sharply in Q4 and, on average, grew by 1.1% year-on-year, well short of the 4.3% recorded in Q3. GDP growth for 2008 was down to 4% from 5.9% in 2007. This performance is due to the adverse impact the financial crisis has had on credit conditions, heightening the domestic demand contraction, and to the gradual deterioration in external demand from the euro area countries. The higher-frequency indicators point to a more pronounced drop in industrial production and exports in early 2009. In March, the aggregate rate of inflation remained at 4.1% year-on-year because of the increase in Poland and the Czech Republic (due in both cases to the effects of the previous exchange rate depreciation), while it continued falling elsewhere. Virtually all the countries with floating exchange rates announced further interest rate cuts in the quarter. The financial difficulties that had dominated the economic situation until February faded slightly in March. Nevertheless, the rating agencies downgraded their credit ratings on Hungary, Latvia and Lithuania, whilst maintaining their negative outlook on this group of countries overall (Poland and the Czech Republic are the exceptions). In this setting, and as explained in Box 2, external financial support for the region increased.

In China, GDP rose by 6.1% year-on-year in Q1; this represents a decline of 0.7 pp compared with the previous quarter and is the lowest rate of the last ten years, due to significant deterioration in the external sector and to the ongoing adjustment in the real estate sector. Nonetheless, the fiscal and monetary stimulus packages would appear to be starting to bear fruit, as supply indicators such as industrial production and business confidence recovered in March and demand indicators, especially investment in fixed assets, gained momentum. The foreign trade surplus, while still high, fell considerably in Q1 due to the sharp decline in exports and despite the significant drop in imports. In the year overall, however, the current account surplus rose by 20% to stand at 10% of GDP. The decline in the trade surplus, the decrease in foreign direct investment and the outflow of speculative capital, possibly accompanied by valuation effects, meant that the accumulation of international reserves eased off considerably in the last quarter of the year, although they still almost reach the \$2 trillion mark. Inflation recorded negative year-on-year rates (-1.6% in February and -1.2% in March) for the first time since 2002 and the decline in producer prices intensified due to a base effect. Nevertheless, the moderately lax monetary policy led to a sharp rebound in both the money supply and credit in the quarter. At the same time, policies were implemented to reduce dollar dependence in commercial transactions. As regards fiscal policy, the budget approved in March envisages an increase in the budget deficit to 3% of GDP in 2009, but no extension of the existing fiscal stimulus programme.

In the rest of Asia, GDP growth fell sharply in most of the region's economies in 2008 Q4, especially in South Korea, Hong Kong, Singapore, Malaysia and Thailand, and much more moderately in India, Indonesia and the Philippines, all in year-on-year terms. In general, the most recent indicators also reflect a sharp year-on-year decline in exports and industrial production, so we can expect to see a further slide in GDP growth in 2009 Q1. Inflation continued to decline throughout the region in the first quarter, falling to 10-year lows, as private consumption continued to moderate; in fact some countries (for example, Thailand) even recorded negative year-on-year rates. Against this backdrop, official interest rates were cut throughout the region in the quarter.

In Latin America, economic growth decreased significantly in 2008 Q4 in comparison with the previous quarter, taking year-on-year growth down to just 1%, from 5% in Q3. This economic slowdown, which was most noticeable in countries such as Brazil, Mexico and Chile, was a result of the credit crunch caused by the international financial crisis, which had a severe impact not only on domestic demand but also on imports and exports. Also contributing to this effect was the lack of momentum in the international economy and the decline in commodities prices. The latest activity indicators point to persistent economic deterioration in 2009 Q1. Inflation moderated further to 7.4% in February, 1.2 pp below the November figure. This enabled the region's central banks to make large-scale interest rate cuts: thus rates were cut by 650 bp in Chile, by a more moderate 250 bp in Brazil and Colombia, by 225 bp in Mexico and by 150 bp in Peru. Against a backdrop of lower exports and imports, the region's current account balances remained weak, but financial flows recovered somewhat and, in consequence, sales of international reserves fell back, save in the case of Mexico where strong depreciation pressure persisted. In any case, the authorities continued to take measures to supply dollar liquidity, and in this respect Mexico was particularly active, making use of the new IMF \$47 bn Flexible Credit Line and of the \$30 bn swap facility with the Federal Reserve designed to supply funds to the business sector. Colombia also requested \$10.4 bn from the new IMF Flexible Credit Line, while in Argentina the central bank launched a mechanism to supply liquidity to the export sector. Several countries saw a significant deterioration in their fiscal position, as revenues declined, but both Chile and Peru launched fiscal expansion programmes, Brazil announced a housebuilding programme and Colombia designed a structural investment programme partly funded by the IDB. Moreover, in another positive development, especially in the present circumstances, Moody's upgraded its sovereign credit rating on Chile.

3 The euro area and the monetary policy of the European Central Bank

According to the latest available data on economic developments in the euro area, GDP again deteriorated significantly in the opening months of 2009. The European economy is being hit not only by the serious financial crisis, which continued to hamper activity due to tight credit standards and its repercussion on agents' confidence, but also by the sharp decline in world trade seen in 2008 Q4, which intensified at the beginning of 2009 (see Box 3). In the more medium term, economic prospects remain subject to an extraordinary level of uncertainty. The latest forecasts from private institutions and international organisations estimate that GDP in the euro area will continue to post negative growth rates throughout 2009, although the pace of decline should gradually lessen as signs of normalisation appear in the financial markets and as the effects of economic policy measures materialise. There would be no return to positive, albeit moderate, growth rates until 2010. Nevertheless, the synchronised global nature of the current recession poses new challenges for the euro area, as, in the past, cyclical recovery was driven by external demand.

Inflation continued to decline in the first months of 2009, to an all-time low since the creation of the euro area, as a result of base effects in commodities and food prices and, to a lesser extent, of sluggish domestic demand. Both factors will continue to weigh on prices in coming months, meaning that inflation could temporarily register negative rates in the summer. Into the medium term, inflation rates will foreseeably remain very moderate for a prolonged time period, in a context in which weak aggregate demand will contribute in coming quarters to a significant increase in the slack present in the product and labour markets.

As inflationary pressures have disappeared from the policy-relevant horizon, the ECB Governing Council decided to continue to ease its monetary policy stance, with further rate cuts in the January-March period that took the official interest rate to 1.25%, 300 bp below the September level. The ECB President also indicated that the Council intended to consider adopting new extraordinary monetary policy measures at its first meeting in May. At the same time, the Council reiterated that it was important, in the present circumstances, to anchor inflation expectations around the medium-term target of rates close to but below 2%, as an essential basis for sustainable growth and employment and to support financial stability.

In the absence of any sign of improvement in the economic situation, the economic authorities continued to support the financial system and activity. The Eurosystem continued with its generous funding policy – via fixed-rate tenders with full allotment and US dollar liquidity-providing operations – and governments continued to implement the financial system support measures approved in October, chiefly in the form of guarantees for new medium-term bank debt and public capital injections for financial institutions. In addition, under the European Economic Recovery Plan approved by the European Council at the end of 2008, the European and national authorities also adopted further stimulus measures to bolster demand. These measures, combined with the activation of the automatic stabilisers in a notably deteriorated economic setting, will entail a significant and generalised impairment of European public finances in 2009.

3.1 Economic developments

The second National Accounts estimate confirms the severe contraction in euro area activity in the closing months of 2008, as the financial crisis intensified and the global economy slowed. GDP fell by 1.6% in 2008 Q4, signifying a decline of 1.5% year-on-year, after the growth rates of –0.3% and +0.6%, respectively, in the period July-September (see Chart 8). In 2008 as a

The notable contraction in activity in the euro area in 2008 Q4 was largely due to the poor performance of exports, in line with the collapse in global demand. Thus, imports of goods worldwide shrank in this period – for the first time since 2002 Q1 – at a rate of 2.9% year-on-year. On the data available, this trend worsened in early 2009, against the background of further deterioration of the global economic situation and tightening credit standards as a result of extreme risk aversion and deleveraging in the financial system (see Panel 1). Moreover, the decline in import demand has not only been confined, as was the case previously, to the developed countries, but has spread forcefully to the emerging economies in recent months. In fact, emerging market imports, which had slowed notably in 2008 Q4, fell sharply – by some 17% – in January-February, almost 2 pp more than the decline recorded by the industrialised countries. Among the latter group, US imports, which had been diminishing since 2007 Q4, fell by 19.2%, while in Japan and the euro area they contracted by 14.8% and 13.3%, respectively.

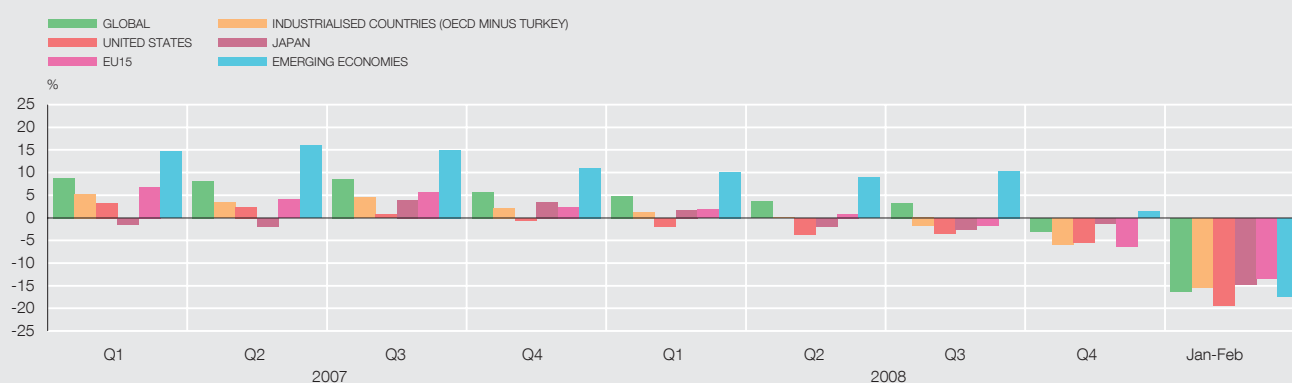
These developments in world markets heightened the rate of decline of euro area exports to all destinations, but especially exports outside the euro area, which fell by some 24% in January and February (approximately 3 pp more than exports within the euro area), due to the collapse in sales both to the developed economies – especially the United States – and the emerging markets. Among the latter, exports to China and Russia fell by more than 30% in

January, while exports to south-east Asia and Latin America fell by around 20%.

All the euro area countries have seen a sharp decline in exports, although this has been especially true for Spain, France and Italy where exports have fallen by some 25% in nominal terms. In Germany, too, sales have fallen considerably, and this is having a major impact on economic activity, due to the significance the export sector has acquired in recent years.

The outlook for euro area exports, the driving force behind economic recovery in previous cycles, is not favourable. In the short term, European Commission surveys show that, in recent months, export firms' assessments of export order books have continued to decline, reaching an all-time low in March since the series was created in 1985. Meantime, export expectations, which are highly correlated with exports of goods and services, collapsed to unprecedented levels in 2009 Q1 (see Panel 2). These surveys also show that exporters believe their competitive position deteriorated in Q1, both within the euro area and beyond. In the more medium term, the latest IMF and OECD forecasts point to an overall decline in import demand in 2009, deeper in the developed countries but also persistent in many of the emerging markets (see Panel 3). In any case, even in those regions where import demand is likely to grow in 2009 – China, Latin America, Africa and the Middle East – the rate of growth will be much lower than in 2008.

1 IMPORTS OF GOODS BY REGION (a)



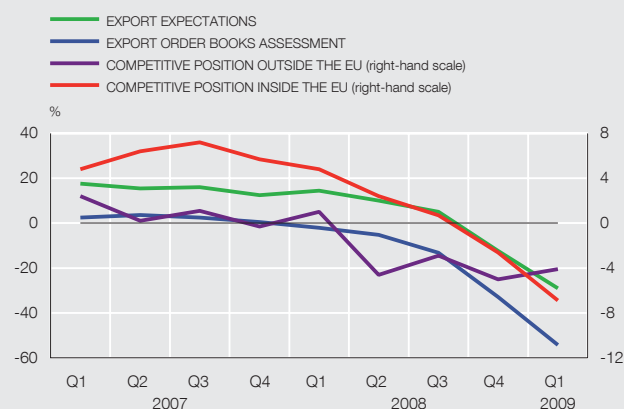
SOURCES: OECD Economic Outlook, European Commission and CPB Netherlands Bureau for Economic Policy Analysis.

a. Year-on-year growth rates.

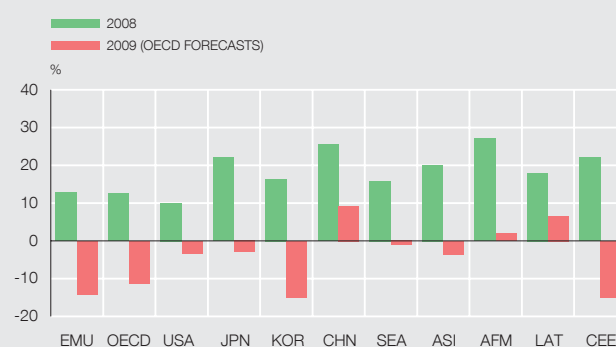
EURO AREA GOODS EXPORTS. BREAKDOWN BY AREA (VALUE) (a)

	WEIGHT	2008				2009	
		Q1	Q2	Q3	Q4	JAN	FEB
TOTAL		5.0	7.6	5.4	-6.8	-23.3	-22.6
Destination:							
Intra-Euro area	47.3	3.3	6.7	5.1	-8.5	-21.9	-21.4
Extra-Euro area	52.7	6.8	8.5	5.6	-5.0	-24.8	-23.9
United Kingdom	12.4	-0.3	3.1	-3.4	-14.7	-28.7	
Rest of EU (except UK)	18.1	8.7	11.4	8.3	-7.8	-25.0	
Canada	1.2	3.5	1.2	0.4	-1.9	-20.1	-20.7
Switzerland	5.7	1.3	12.5	5.4	1.6	-7.8	-11.2
Norway	1.1	6.7	9.3	-4.3	-11.9	-26.7	-26.7
Russia	4.7	23.4	22.6	19.8	-1.0	-35.1	-35.4
United States	12.1	-1.6	-3.3	-5.0	-7.8	-26.5	-18.6
Africa	8.0	11.2	16.8	22.4	12.6	-10.0	-9.4
Latin America	5.1	5.5	9.0	16.0	11.9	-22.8	-20.3
Japan	2.4	-2.4	-2.4	-1.9	0.2	-22.6	-17.6
South-east Asia	3.1	10.7	4.1	8.0	-3.1	-18.5	
China	4.6	17.2	15.6	4.3	-0.8	-25.9	-17.0
Origin:							
Germany	32.9	6.2	8.5	4.2	-6.1	-23.4	-23.2
France	13.2	6.5	5.2	4.6	-7.0	-23.7	-24.0
Italy	9.8	-0.1	4.8	3.7	-7.0	-25.8	-25.3
Spain	6.0	-1.8	3.5	3.8	-10.1	-25.9	-18.8
Ireland	3.4	-4.7	-7.4	-3.9	-3.4	-2.3	-4.5
Portugal	1.2	5.2	4.6	5.4	-11.0	-28.6	-31.3
Netherlands	14.0	10.3	12.3	12.3	-5.1	-21.6	-21.4

2 OPINION INDICATORS



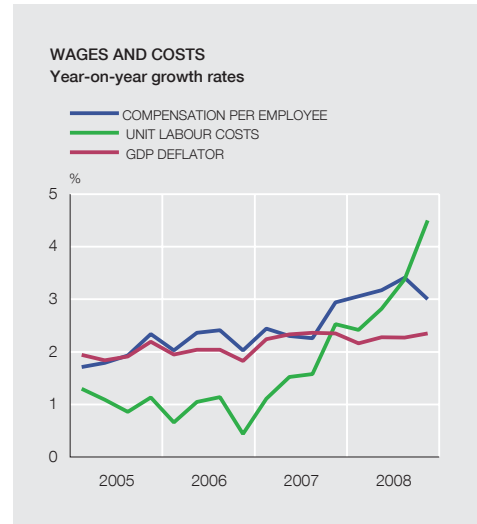
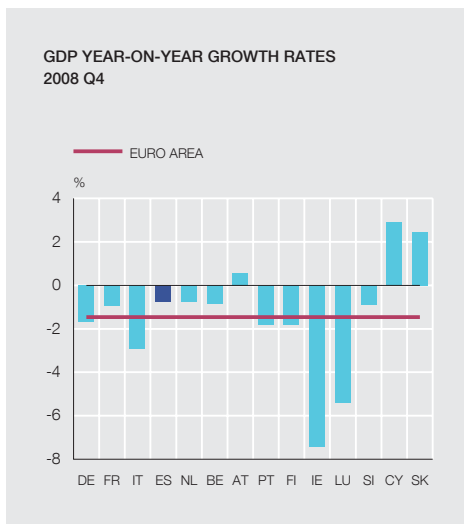
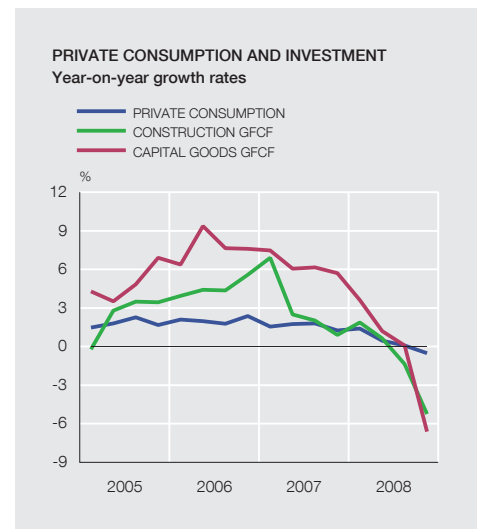
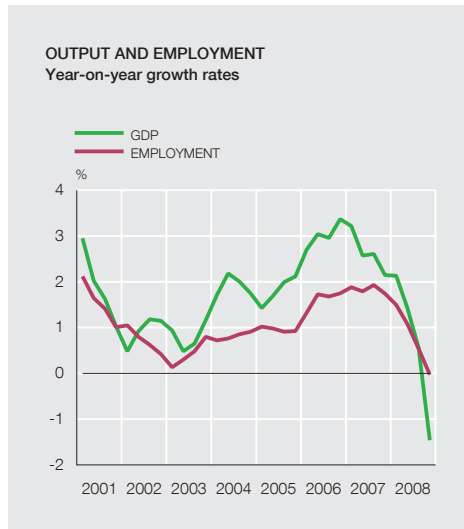
3 NOMINAL IMPORTS OF GOODS AND SERVICES IN US DOLLARS (a) (b)



SOURCES: OECD Economic Outlook, European Commission and CPB Netherlands Bureau for Economic Policy Analysis.

a. Year-on-year growth rates, except for Panel 2.

b. JPN: Japan; KOR: Republic of Korea; CHN: China; AFM: Africa and Middle East; SEA: emerging Asia; ASI: Asia, excluding China and emerging Asia; LAT: Central and South America; CEE: Central and Eastern Europe.



SOURCES: Eurostat and national statistics.

whole, GDP grew by 0.7%, almost 2 pp below the 2007 figure, mainly as a result of the deterioration in domestic demand.

As shown in Table 1, the sharp fall in GDP in the euro area in Q4 was largely due to the significant decline in gross fixed capital formation and exports. All investment components, but especially equipment investment, headed down as a result of the tighter credit standards and poor economic expectations. Moreover, the tighter financial conditions, along with the unfavourable employment performance and falling confidence, had an adverse impact on private consumption, while government consumption continued to grow, albeit at a slower pace than in the previous quarter. Thus, domestic demand, excluding inventories, subtracted 1 pp from the growth rate of GDP. Moreover, the worsening of the global economic situation weighed down the demand for euro area exports both in the developed and the emerging economies (see Box 3). Imports also fell, hit by weak domestic demand, though to a lesser extent than exports, meaning that the net external balance made a negative contribution to GDP growth similar to that of domestic demand. Lastly, changes in inventories maintained their positive contribution to GDP at 0.3 pp. The breakdown by branch of activity shows a decrease in value added most particularly in industry but also in construction and trade.

	2007		2008			2009		
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
NATIONAL ACCOUNTS (quarter-on-quarter growth, unless otherwise indicated)								
GDP	0.6	0.5	0.6	-0.2	-0.2	-1.6		
Private consumption	0.5	0.3	0.0	-0.3	0.1	-0.3		
Public consumption	0.5	0.3	0.4	0.9	0.6	0.4		
GFCF	0.9	0.9	1.0	-1.2	-0.7	-4.0		
Imports	1.9	-0.1	1.2	-0.6	1.2	-4.7		
Exports	1.7	0.7	1.5	-0.2	-0.3	-6.7		
Contributions to quarter-on-quarter GDP growth (pp)								
<i>Domestic demand (excl. inventories)</i>	<i>0.6</i>	<i>0.4</i>	<i>0.3</i>	<i>-0.3</i>	<i>0.0</i>	<i>-1.0</i>		
<i>Changes in inventories</i>	<i>0.1</i>	<i>-0.3</i>	<i>0.2</i>	<i>-0.1</i>	<i>0.3</i>	<i>0.3</i>		
<i>Net foreign demand</i>	<i>-0.1</i>	<i>0.3</i>	<i>0.2</i>	<i>0.1</i>	<i>-0.6</i>	<i>-0.9</i>		
GDP (annual growth)	2.6	2.2	2.2	1.5	0.6	-1.4		
ACTIVITY INDICATORS (quarterly average)								
IPI seasonally and working-day adjusted	0.6	1.1	1.5	-2.0	-2.6	-6.2	-6.3	
Economic sentiment	109.2	105.0	101.4	97.5	89.9	75.8	65.7	
Composite PMI (b)	56.5	54.0	52.1	50.8	47.6	40.2	37.6	40.5
Employment	0.4	0.3	0.4	0.1	-0.1	-0.3		
Unemployment rate	7.4	7.3	7.2	7.4	7.6	8.0	8.4	
PRICE INDICATORS (annual growth of end-period data)								
HICP	2.1	3.1	3.6	4.0	3.6	1.6	0.6	
PPI	2.7	4.6	5.7	7.7	7.6	1.1	-1.7	
Oil price (USD value)	78.2	91.5	104.3	132.0	98.1	40.5	46.8	50.4
FINANCIAL INDICATORS (end-period data)								
Euro area ten-year bond yield	4.4	4.4	4.2	4.9	4.5	3.8	4.1	4.1
US-euro area ten-year bond spread	0.15	-0.36	-0.69	-0.88	-0.88	-1.76	-1.31	2.98
Dollar/euro exchange rate	1.418	1.472	1.581	1.576	1.430	1.392	1.331	1.323
Appreciation/depreciation of the NEER-22 (c)	3.7	6.3	3.7	3.5	-0.6	2.7	-0.7	-2.4
Dow Jones EURO STOXX 50 index (c)	6.4	6.8	-17.5	-23.8	-30.9	-44.3	-15.5	-5.4

SOURCES: European Commission, Eurostat, Markit Economics, ECB and Banco de España.

a. Information available up to 24 April 2009. The information in italics does not cover a full quarter.

b. April data corresponds to the flash estimate.

c. Percentage change over the year.

GDP contracted notably in the main euro area economies in 2008 Q4, although the various demand components contributed differently. In particular, the 2.1% decline in GDP in Germany was due to the poor performance of external demand and, to a lesser extent, of investment, while changes in inventories continued to contribute positively. In Italy, the 1.9% drop in GDP was due, above all, to the reduction in domestic demand and, to a lesser extent, in net exports, whilst in France changes in inventories had the most impact on GDP, which fell by 1.1%.

Employment growth was negative in 2008 Q4 (-0.3%), giving a zero rate of change vis-à-vis the previous year for the euro area overall, although with significant differences across the member countries (see Chart 8 and Box 4). Since GDP decreased by more than employment, apparent labour productivity fell by 1.4%. This, together with the 3% growth in compensation per employee, resulted in an acceleration in unit labour costs (which rose by 4.5% year-on-year). As the GDP deflator recorded lower growth (+2.4%), unit margins shrank again in the closing months of the year.

The latest conjunctural figures suggest that real activity in the euro area probably contracted again significantly in 2009 Q1. On the supply side, the first two months of the year saw a

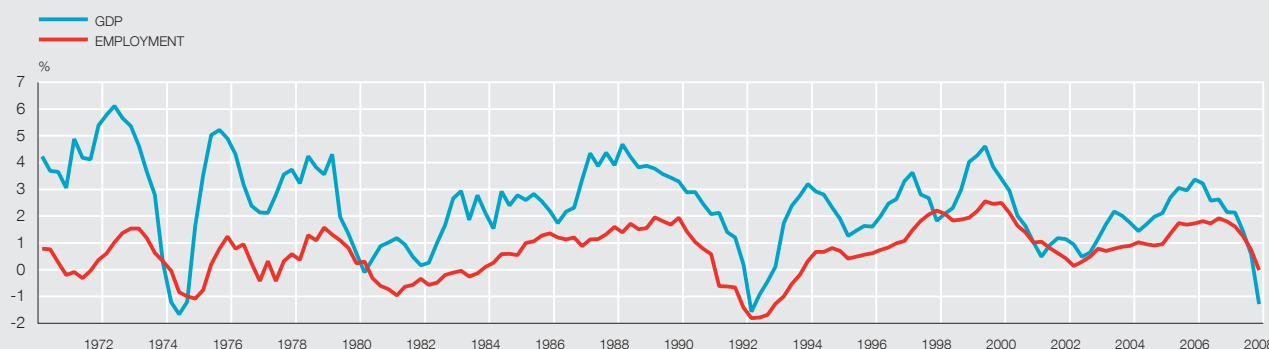
Since mid-2008, employment in the euro area has posted negative quarter-on-quarter growth rates. Indeed, by the end of 2008, employment had returned to 2007 levels. Similarly to comparable periods in the past, the labour market adjustment has affected mostly male workers, younger workers and those on temporary contracts, and its immediate corollary has been a rebound in unemployment. In February 2009 the unemployment rate stood at 8.5%, 1.3 pp higher than a year earlier.

Nevertheless, to date the labour market adjustment in the euro area is proving much more contained – at least relative to the scale of the contraction in activity – than in most previous downturns, and is comparable

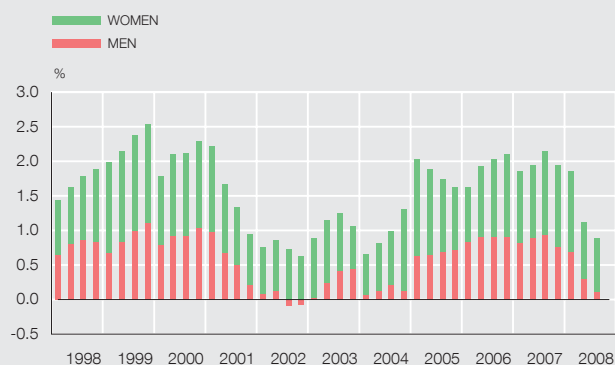
only to the crisis of the early 1970s (see Panel 5). The uncertainties regarding the duration and intensity of the present recession would appear to have prompted firms to opt, at least initially, for labour hoarding.

Public policies in some euro area countries may also be contributing to this delayed response. Thus, for example, in Germany programmes have been launched or reinforced that encourage firms, via public subsidies, to reduce working hours (*kurzarbeit*) rather than make layoffs. These measures are reflected in the significant decrease in hours worked per person in Germany in 2008 Q4: -1.6%, in comparison with -0.1% in 2008 Q3. More recently, countries such as Belgium, Austria, France and the Netherlands have

1 EMPLOYMENT AND GDP
Year-on-year growth rates



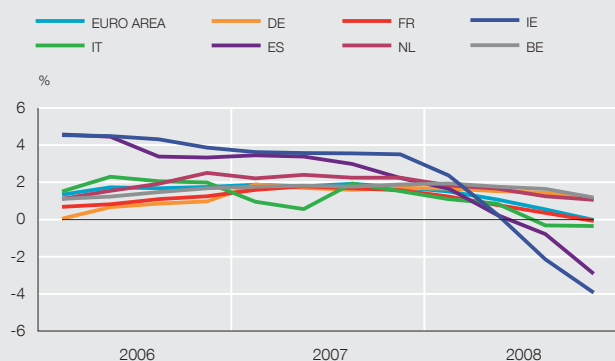
2 EMPLOYMENT GROWTH BY SEX



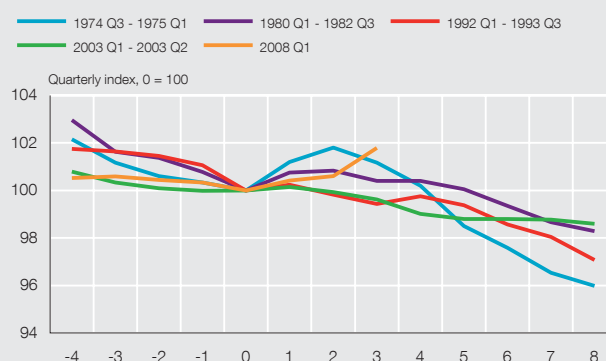
3 SALARIED EMPLOYMENT GROWTH: TEMPORARY VERSUS PERMANENT EMPLOYMENT



4 EURO AREA AND SEVERAL COUNTRIES: ASYNCHRONOUS EMPLOYMENT ADJUSTMENT



5 EMPLOYMENT/GDP



SOURCES: OECD and Eurostat.

introduced or extended the scope of similar programmes aimed at containing job destruction.¹

Aggregate employment figures for the euro area mask highly differentiated behaviour across the member countries: whilst in Belgium, Germany and the Netherlands employment was still growing at a rate of more than 1% at the end of 2008, in Spain and Ireland, and to a lesser extent in Italy, employment started to fall in the second half of the year, declining in Spain and Ireland in Q4 by some 3%. Despite a relative degree of synchrony in the adjustment in activity, the differences in employment trends across the euro area countries may largely be attributed to the different weight of investment in residential building in the last cyclical upturn. This was the first sector to feel a relatively sharp correction in 2008, and it is precisely in those coun-

1. Two countries – Germany and Austria – have also approved additional aid (reductions in social security contributions) for firms in the case of workers taking part at the same time in training programmes.

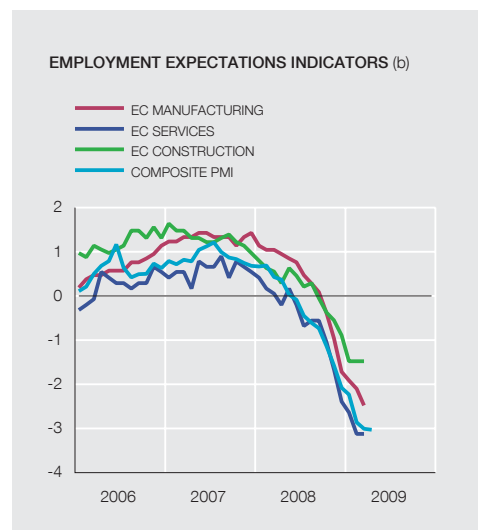
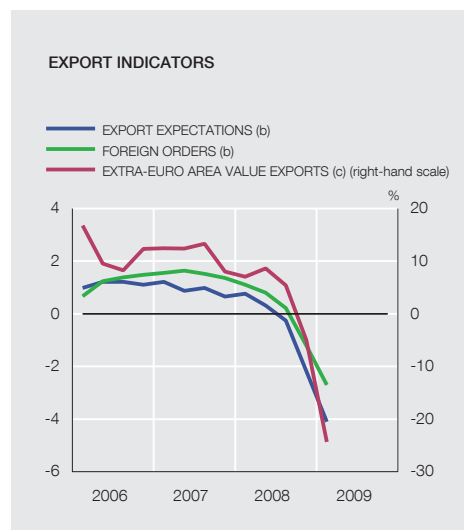
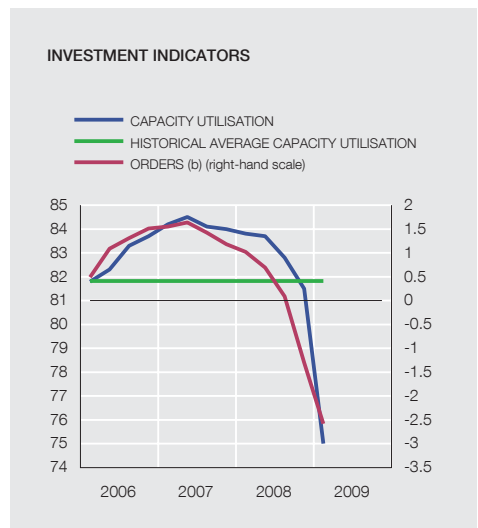
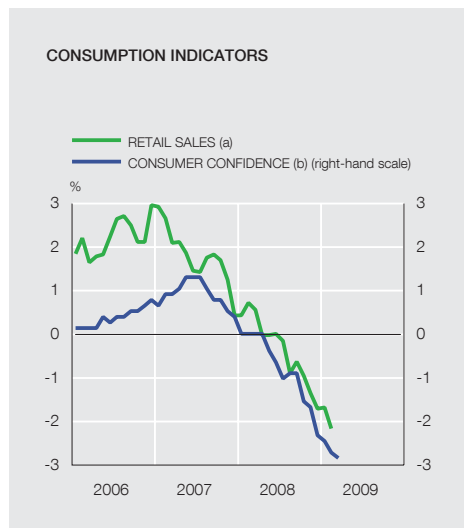
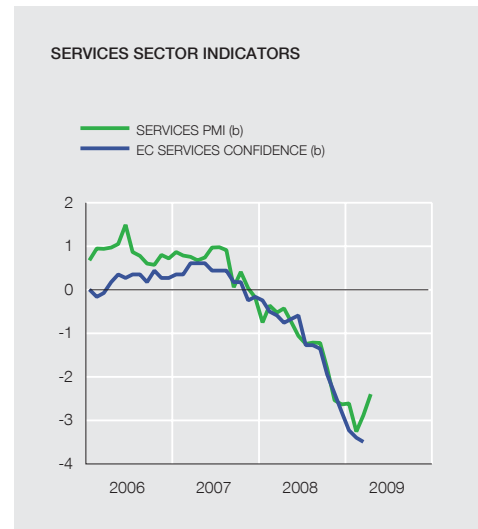
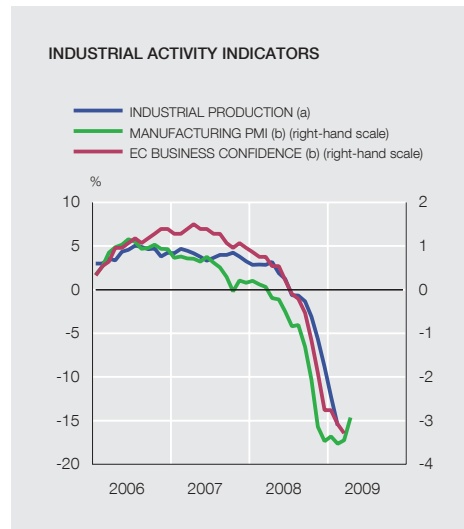
tries that had seen the most expansion in construction in the past – Spain and Ireland – where employment has been hardest hit. By contrast, in countries in which construction played a residual role in the recent upturn, such as Germany, Belgium and the Netherlands, employment creation remained relatively strong in 2008.

In the medium term, the outlook for employment is less favourable. The latest European Commission forecasts released in January 2009 pointed to a more severe correction ahead, envisaging a job destruction rate of 1.06% at the end of 2009 (in comparison with –0.4% forecast in November 2008), taking the unemployment rate to 8.7%. Since then the economic outlook has deteriorated significantly, pushing back in time the expectations of economic recovery and possibly offsetting the effects of the employment measures introduced, entailing an even sharper decrease in the employed labour force. Among the most recent forecasts by international organisations, the OECD's Interim Report published in March envisages a substantial rise in the unemployment rate, to 11.1% in 2009 and 11.9% in 2010.

notable decline in industrial production and, to a lesser extent, in construction industry output and the industrial order book (see Chart 9). Moreover, European Commission and purchasing managers' surveys (PMI) recorded a further deterioration in confidence across all sectors in quarterly average terms, down to all-time lows in industry and services. The latest information available shows that labour market conditions also deteriorated: employment expectations indicators continued to decline in all sectors and the unemployment rate rose progressively, up to 8.5% in February.

On the demand side, the spending-related indicators augur no improvement in private consumption in 2009 Q1. Thus retail sales and new car registrations fell on figures up to February, despite the measures introduced – chiefly by the German government – to foster new car sales. Moreover, European Commission retail and consumer confidence indicators continued to decline in the period, with consumer confidence hitting an all-time low. As regards investment in capital goods, capacity utilisation according to the Commission's quarterly survey and assessment of order books both contracted in Q1. External demand data were also negative in the last few months; in particular, nominal trade balance data show that export sales fell significantly year-on-year in the first two months of 2009, while both average assessment of export order books and export expectations point to continued extreme weakness in external demand. Lastly, the latest Commission indicators available on the assessment of inventories suggest a downward adjustment in the first quarter of the year.

In short, the latest available data all signal a deterioration in GDP in the opening months of the year, potentially similar in extent to that seen in the last months of 2008, in an environment in which there is still no sign of a rapid solution to the global financial crisis and in which the synchronised global nature of the economic crisis is profoundly impacting external demand. In the more medium term the outlook remains highly uncertain, as it is extremely difficult to predict how the financial situation will unfold and how it will affect the real economy. The most recent projections of private analysts and various international organisations suggest that euro area GDP may contract by some 4% in annual average terms in 2009, ahead of a gradual recovery in 2010 (see Table 2).



SOURCES: European Commission, Eurostat and Markit Economics.

a. Non-centred annual percentage changes, based on the quarterly moving average of the seasonally-adjusted series.

b. Normalised series.

c. Original series year-on-year changes. Quarterly average.

	2009		2010	
	GDP	HICP	GDP	HICP
ECB (March 2009)	Between -3.2 and -2.2	Between 0.1 and 0.7	Between -0.7 and 0.7	Between 0.6 and 1.4
European Commission (January 2009)	-1.9	1.0	0.4	1.8
IMF (April 2009)	-4.2	0.4	-0.4	0.6
OECD (March 2009)	-4.1	0.6	-0.3	0.7
Consensus Forecast (April 2009)	-3.4	0.4	0.3	1.3
Eurobarometer (April 2009)	-3.2	0.5	0.3	1.2

SOURCES: European Commission, Consensus Forecast, Eurosystem, IMF, MJ Economics and OECD.

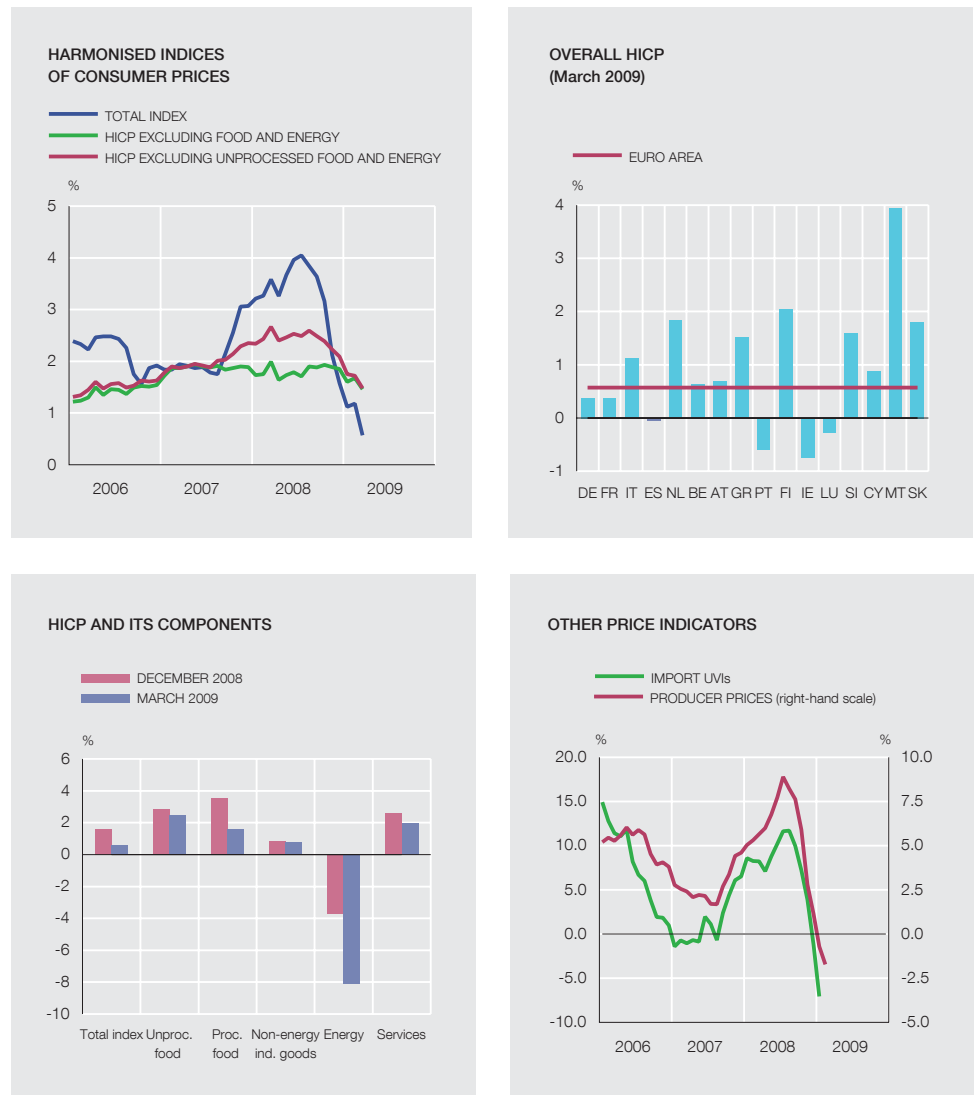
a. Year-on-year growth rates.

Turning to inflation, the HICP gradually decelerated in 2009 Q1, posting a year-on-year growth rate of 0.6% in March, 1 pp down on December (see Chart 10). This slowdown was largely due to base effects in the processed food and energy components, stemming from the high prices seen in 2008, and, to a lesser extent, to the slowdown in services prices (affected by calendar effects as the Easter holidays fell in March last year). Growth rates in the other sub-indices – unprocessed food and non-energy industrial goods – were more volatile throughout the quarter. Core inflation, measured by the overall index excluding unprocessed food and energy, declined by 0.6 pp between December and March to 1.5%. Producer prices turned negative year-on-year in the first two months of 2009, as energy and intermediate goods prices fell significantly.

Inflation is expected to continue to decline in coming months, temporarily posting negative rates in the summer, mainly as a result of base effects in energy and food prices. In the medium term, price developments will depend on the extent to which the components most sensitive to demand, which so far are not clearly decelerating, respond to the emergence of a sizeable output gap. How wages will react is particularly uncertain, as so far they have been highly determined by wage agreements set in previous months, before neither the extent nor the duration of the economic slowdown became clear.

ECB figures show that the current account deficit stood at €18.2 bn in January 2009, up on the €14.7 bn deficit in the same month a year earlier, reflecting deterioration in all components with the exception of current transfers whose deficit declined. Thus, as exports fell by more than imports, the deficit on trade in goods widened, the services surplus narrowed and the income balance recorded a deficit, in comparison with a surplus a year earlier. In January, net capital outflows in the form of direct investment and portfolio investment amounted to €19.5 bn and €3.3 bn, respectively (in comparison with –€64.9 bn and €58.4 bn in 2008). Overall, the deficit on the basic balance, which aggregates these two sub-balances and the current account balance, rose by almost €20 bn to €41 bn (see Chart 13).

The demand stimulus measures introduced by most of the euro area countries since October, under the European Economic Recovery Plan approved by the European Council in December 2008, and the activation of the automatic stabilisers, which in Europe are relatively powerful, are having a major impact on public finances. In this context, the 2009 euro area budget deficit can be expected to exceed the Commission's 4% forecast issued in January this year. In fact the latest forecasts by other international organisations place it over 5%, which implies a significant deterioration in comparison with the deficit of 1.7% in 2008 (see Table 3).



SOURCES: Eurostat and ECB.

In recent months, most euro area countries have implemented the fiscal stimulus plans to boost demand that were ratified last year. Germany for its part approved a third raft of measures in January. Overall these measures are equivalent to close to 1% of euro area GDP.

In light of the deteriorating budget situation, in February 2009 the European Commission launched the excessive deficit procedure against all those countries whose deficit exceeded 3% of GDP in 2008: France, Spain, Ireland, Greece and Malta. In accordance with the margins of flexibility envisaged in the Stability and Growth Pact, the Council, on the Commission's recommendation, agreed to give France and Spain until 2012, and Ireland until 2013, to bring their deficits below 3%.

3.2 Monetary and financial developments

During the opening months of the year, the situation on the financial markets improved somewhat, in comparison with the extremely tense climate of late 2008, although credit standards remained very tight, in a context of high risk premia and volatility. On the interbank market, the yield spread between the EURIBOR and the secured interbank transactions interest rate (EUREPO) gradually narrowed to the levels seen before the collapse of Lehman Brothers in September last year. Although still quite high, corporate private debt spreads also narrowed,

GENERAL GOVERNMENT BUDGET BALANCES
AND PUBLIC DEBT OF EURO AREA COUNTRIES (a)

TABLE 3

	% of GDP							
	BUDGET BALANCES (a)							
	2007	2008		2009			2010	
	SP (b)	EDP (c)	SP (b)	EDP (c)	EC (d)	SP (b)	EC (d)	
Belgium	-0.3	0.0	-1.2	0.3	-3.4	-4.5	0.7	-6.1
Germany	-0.2	0.0	-0.1	-3.0	-2.9	-3.9	-4.0	-5.9
Greece	-3.8	-3.7	-5.0	-3.7	-3.7	-5.1	-3.2	-5.7
Spain	2.2	-3.4	-3.8	-5.8	-5.8	-8.6	-4.8	-9.8
France	-2.7	-2.9	-3.4	-3.9	-5.6	-6.6	-2.7	-7.0
Ireland	0.2	-6.3	-7.1	-9.5	-9.9	-12.0	-9.0	-15.6
Italy	-1.5	-2.6	-2.7	-3.7	-3.7	-4.5	-3.3	-4.8
Luxembourg	3.2	2.0	2.6	-0.6	-1.7	-1.5	-1.5	-2.8
Netherlands	0.3	1.2	1.0	-1.2	-3.3	-3.4	-2.4	-6.1
Austria	-0.5	-0.6	-0.4	-0.2	NA	-4.2	0.4	-5.3
Portugal	-2.7	-2.2	-2.6	-3.9	-3.9	-6.5	-2.9	-6.7
Slovenia	0.5	-0.9	-0.9	-0.6	-3.7	-5.5	0.0	-6.5
Finland	5.3	4.4	4.2	2.1	-1.9	-0.8	1.1	-2.9
Malta	-1.8	-3.3	-4.7	-1.5	-1.5	-3.6	-0.3	-3.2
Cyprus	3.5	0.5	0.9	0.5	-0.8	-1.9	0.7	-2.6
Slovakia	-2.0	-2.3	-2.2	-1.8	-2.1	-4.7	-0.8	-5.4
MEMORANDUM ITEM: Euro area (including Malta and Cyprus)								
Primary balance	2.3		1.1			-2.3		-3.3
Total balance	-0.7		-1.9			-5.3		-6.5
Public debt	66.1		69.3			77.7		83.8

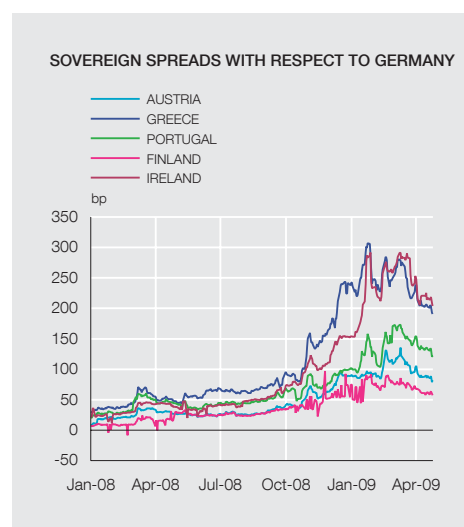
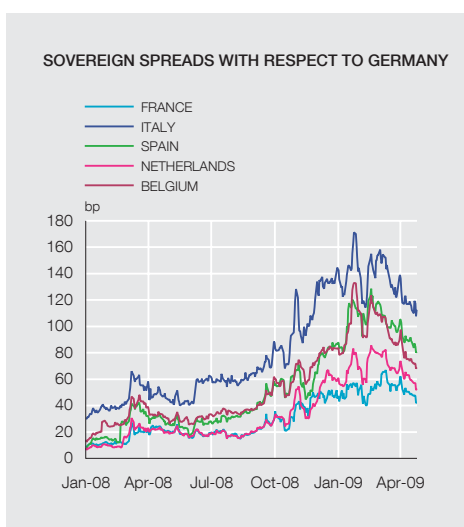
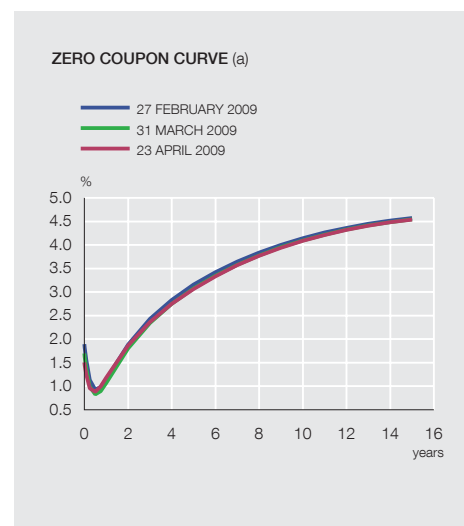
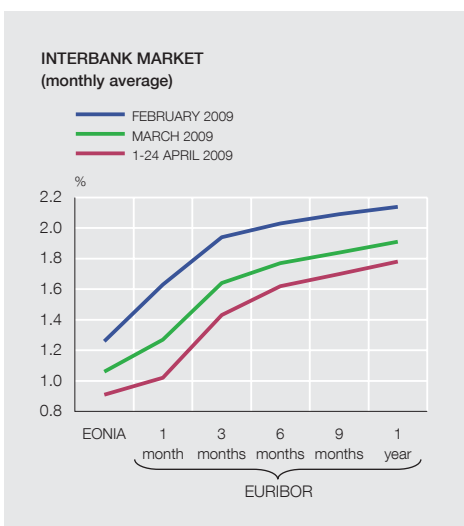
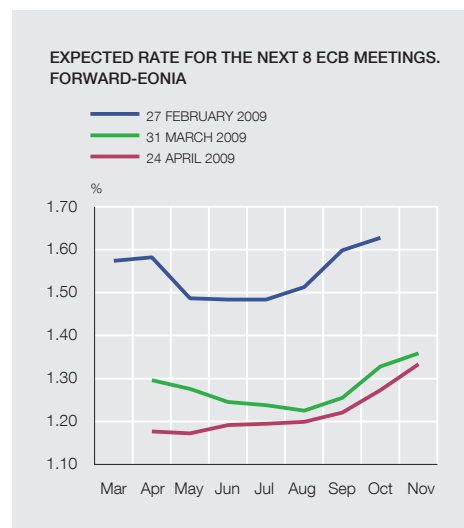
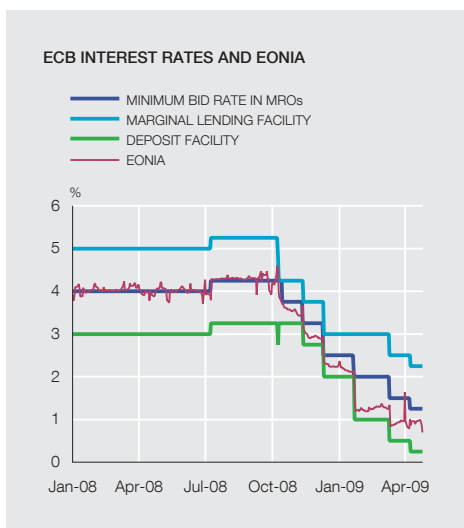
SOURCES: European Commission and national stability programmes.

- a. Deficit (-)/surplus (+). The deficits that exceed 3% of GDP have been shaded.
 b. Stability Programmes' objectives (spring 2009).
 c. Notification of Excessive Deficit Procedure (spring 2009).
 d. European Commission forecasts (April 2009).

especially in the case of lower-rated bonds, and the European bourses headed upward again as from mid-March, driven by positive news from outside the euro area and, subsequently, by the success of the G20 summit.

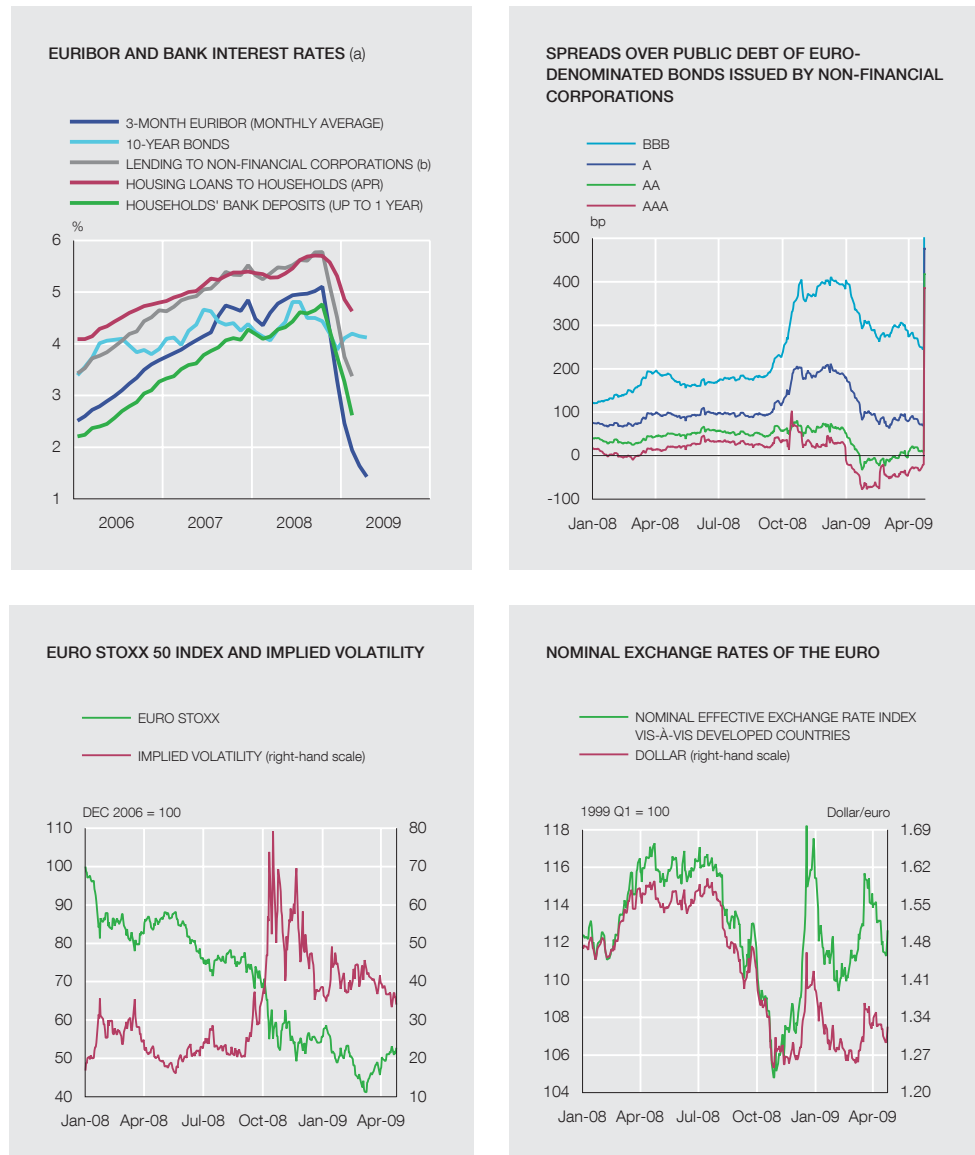
The euro area governments continued to implement the financial system support programmes approved in October, mainly in the form of guarantees for new medium-term bank debt issues and public capital injections for financial institutions. For its part, the ECB continued to provide extensive market liquidity in Q1, with high volumes of funding through fixed-rate tenders with full allotment, both in weekly and more long-term operations, as well as US dollar liquidity-providing operations. In January, the ECB Governing Council decided to re-establish the 200 bp corridor of standing facilities, thus helping reduce the extensive use of the deposit facilities made by banks since October 2008. In March it was decided to continue the fixed-rate tenders with full allotment into 2010 and to extend the dollar liquidity provision agreement with the Federal Reserve until the end of June. In April a new extension of the currency agreement with other national central banks, once again including the Federal Reserve, was announced, to provide euro liquidity via swap agreements up to October 2009.

The decrease in inflationary pressures in the medium term as a result of the decline in commodities prices and the significant slowdown in activity enabled the ECB Governing Council to continue with its significant monetary policy easing in the opening months of 2009.



SOURCES: ECB and Banco de España.

a. Estimated by the ECB using swap market data.

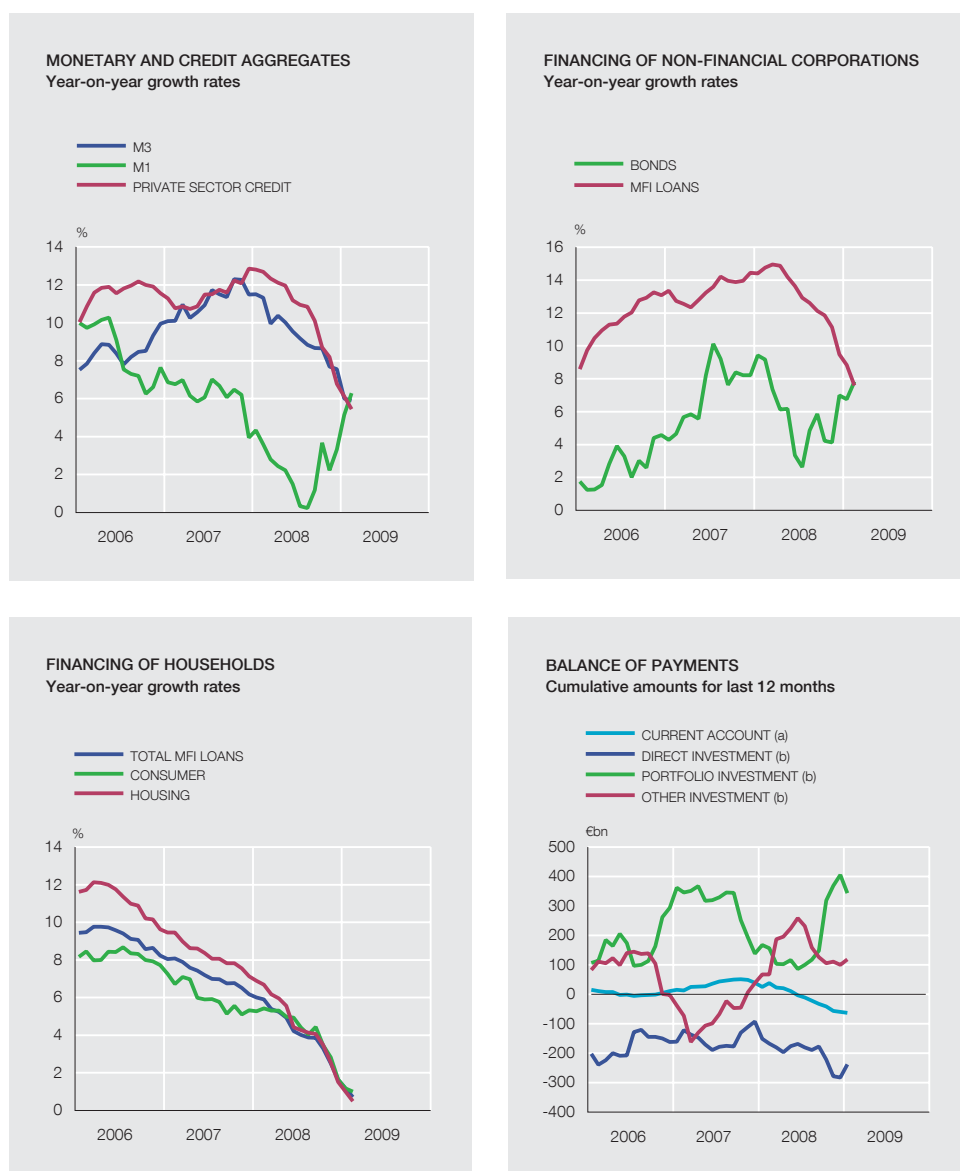


SOURCES: ECB and Banco de España.

- a. For new operations.
- b. Floating interest rates with initial rate fixation of up to 1 year.

The ECB cut official interest rates by 50 bp in January and then again in March, and by a further 25 bp in April, representing an overall rate cut of 300 bp since October 2008. Thus the main refinancing operations, deposit facility and marginal lending facility rates now stand at 1.25%, 0.25% and 2.25%, respectively (see Chart 11). Moreover, the Governing Council reiterated that it was important, in the present circumstances, to firmly anchor expectations around the medium-term target of inflation rates close to but below 2%, which is the most valuable contribution monetary policy can make to sustainable growth, employment and financial stability.

As a result of this monetary easing, and also, albeit to a lesser extent, of the steady decline in credit risk premia, interbank market rates at all terms gradually declined in the opening months of the year. In particular, 3-month and 1-year EURIBOR are now more than 125 bp below their end-December levels, at 1.4% and 1.8%, respectively (see Chart 12). This reduction was passed through – though only partially – to bank lending rates, which continued to



SOURCES: ECB and Banco de España.

- a. A positive (negative) sign indicates a current account surplus (deficit).
- b. Capital inflows less capital outflows. A positive (negative) sign indicates a net capital inflow (outflow).

head downward in the period. In this respect, the Q1 bank lending survey showed further tightening of credit standards – chiefly through higher margins – and a contraction in loan demand, although in both cases to a lesser extent than in 2008 Q4. Lending standards became stricter both for households and firms, as a result of the deteriorating economic situation and the property market adjustment in some EU Member States. In this setting, bank credit to the private sector, which includes loans, stocks and shares, and other securities, continued to decelerate, to 5.4% year-on-year in February. Much of this was due to the significant slowdown in lending which, stripping out securitisations, grew by 5.9%, almost 1.5 pp less than in December. The lower rate of growth was seen in loans to both non-financial corporations and households, although the former continued to grow at a significantly higher pace than the latter (7.6% in comparison with 0.7% in February). A breakdown of household loans shows that all components lost momentum in the first two months of the year, with mortgage loans growing by 0.5%, loans for consumption by 1% and other loans by 1.5%, all in year-on-year terms.

After rebounding early in the year, 10-year government debt yields fell back again as from February, in line with the worsening of the economic outlook for the euro area and the preference of agents for safer assets. Thus, average euro area debt yields were 25 bp lower in March than at end-January, while spreads over Germany remained generally high, due to the high sovereign risk premia and, to a certain extent, to the greater preference for German debt liquidity. Greece, Spain and Portugal all saw their sovereign credit ratings downgraded in January, followed by Ireland in March. Spreads over US government debt yields, which were very volatile in the period, narrowed to around 120 bp.

Stock markets worldwide lost ground in the opening months of the year, with episodes of extreme volatility (see Chart 12), as a result of the delicate global economic situation and the difficulties facing the banking sector, especially in the United States and the United Kingdom. The Euro Stoxx 50 continued to head down until mid-March, but then rebounded on the news of profits at a number of US banks, the rescue plan for the US financial sector and the monetary stimulus programmes launched by various central banks outside the euro area. This positive trend was then reinforced by the agreements reached at the G20 summit in early April. Nonetheless, the rebound was not sufficient to offset the losses accumulated since the end of 2008, which amounted to almost 20%, and the index closed the period to date in 2009 down by more than 5%.

On the foreign exchange markets, the first months of 2009 were marked by extreme volatility. At the date of this Bulletin going to press, the euro was some 2.4% below its end-December level in nominal effective terms, as a result of the disparate performance of bilateral exchange rates. In particular, the euro appreciated against the yen but depreciated against both the pound sterling and the US dollar – by 1.7% and 4.9%, respectively – (see Chart 12).

The M3 monetary aggregate continued to decelerate in the first two months of 2009, to stand at 5.9% in February, 1.7 pp below the December figure, primarily due to the net decrease in term deposits, which slowed considerably. For its part M1, its most liquid component, continued to accelerate, driven by cash in circulation and, above all, by overnight deposits (see Chart 13).

4 The Spanish economy

On Quarterly National Accounts (QNA) estimates, GDP contracted sharply in 2008 Q4, posting year-on-year growth of -0.7% , down 1.8 pp on the previous quarter. The quarter-on-quarter rate was negative (-1%) for the second quarter running. The fall in activity in the closing months of 2008 was, in any event, less steep than in the euro area and in the OECD as a whole. The fall-off in GDP reflected the sharp weakening of national demand, particularly that of households. By contrast, the contribution of the external sector to GDP growth improved substantially by 1.2 pp to 2.3 pp, against a background in which imports slowed more than exports. On the supply side, value added fell in all branches of activity except services. This deterioration in activity was reflected in the behaviour of employment, which on QNA figures posted a year-on-year rate of change of -3.1% .

According to the available information, the fall in GDP quickened in the opening months of 2009, against a background of worldwide recession characterised by the deterioration of agents' confidence, the collapse of international trade and the persistence of strains, albeit somewhat muted, on financial markets. Specifically, the estimated year-on-year change in GDP in 2009 Q1 was -2.9% , down 2.2 pp on that observed in the closing months of 2008. In quarter-on-quarter terms, GDP is estimated to have slipped by -1.8% , which is 0.8 pp more than the fall in 2008 Q4. This behaviour seems to reflect above all the marked decrease in national demand, estimated to have fallen by 4.9% with respect to the same quarter a year earlier. The contribution to GDP growth from the external sector is estimated to have decreased slightly, but to have remained positive (2.2 pp), although the significant falls in world trade, which have considerably affected export and import flows, hamper this estimate enormously (see Chart 14). The value added of the market economy also seems to have decreased more sharply than in late 2008, moving similarly to the available labour market indicators, which point to a quickening of job destruction, with a fall in the employment growth rate of around 6% in year-on-year terms. Since the fall-off in GDP was comparatively smaller, productivity growth seems to have continued to rise, after various years of very low levels. Compensation per employee seems to have continued growing briskly, although less rapidly than in recent quarters, which, together with the step-up in productivity growth, meant that unit labour costs slowed. The year-on-year rate of change of GDP dropped substantially in the opening months of 2009 to a negative value (-0.1%) in March, and the inflation differential with the euro area again fell, standing at -0.7 pp in that month, the lowest value since the creation of the euro area.

4.1 Demand

The profile of marked slowdown in final consumption spending of households and NPISHs throughout 2008 continued in 2009 Q1 (see Chart 15). The various indicators show very negative rates of change, clearly indicating the sharpness of the contraction, although in some cases the observed rates are no worse than those in Q4. Among the quantitative indicators, the tax authorities' data on large corporations for January and February show some moderation in the rates of decline of sales, although consumer services fell more sharply than at end-2008. The retail trade index in real terms also posted a somewhat milder contraction, the same as purchases of consumer durables. In particular, new car registrations decreased by 38% on average in Q1, against a decline of 45% in the previous period. The synthetic indicator of goods and services consumption continued to fall at a rate similar to that at end-2008. Among the qualitative indicators, consumer confidence seemed to steady and retail confidence showed signs of a somewhat clearer improvement.

MAIN DEMAND AGGREGATES (a)

CHART 14

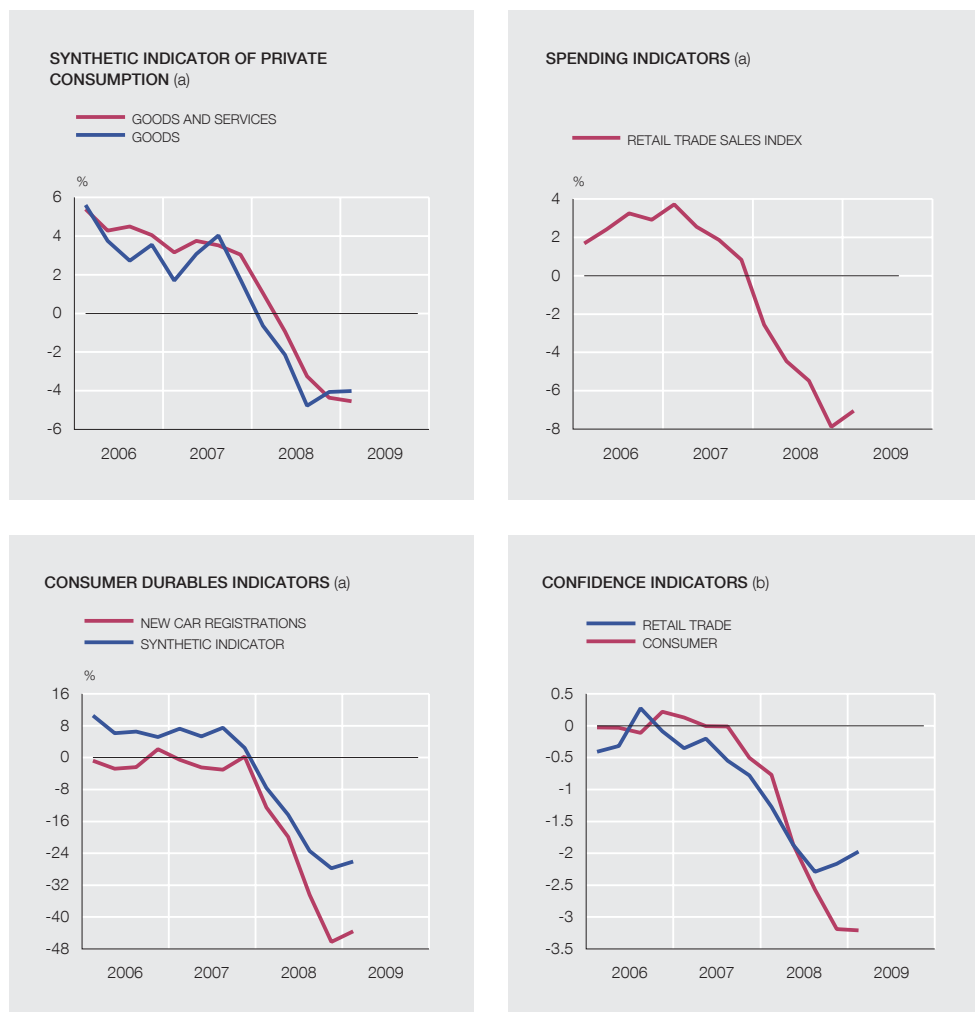


SOURCES: INE and Banco de España.

a. Year-on-year percentage change based on seasonally adjusted series.

PRIVATE CONSUMPTION INDICATORS

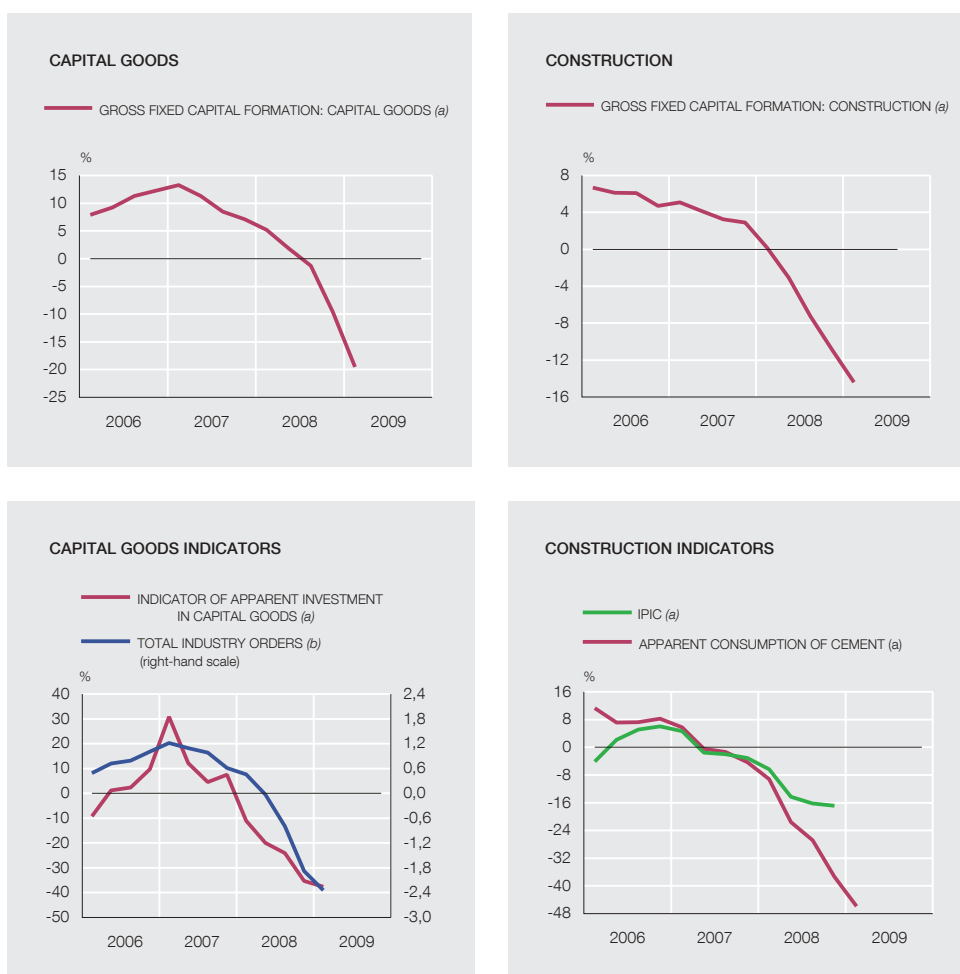
CHART 15



SOURCES: INE, European Commission, ANFAC and Banco de España.

a. Year-on-year percentage change based on the seasonally adjusted series.

b. Normalised indicators (deviation from the mean, divided by the standard deviation).



SOURCES: INE, European Commission, Ministerio de Fomento, OFICEMEN and Banco de España.

- a. Year-on-year percentage change based on the seasonally adjusted series.
 b. Normalised indicator (deviation from the mean, divided by the standard deviation).
 c. Construction Industry Production Index. Year-on-year percentage change based on the seasonally adjusted series

The weak household consumption in 2009 Q1 reflects the setting of high uncertainty in which household spending decisions were made, despite the positive tone of the marked decreases in inflation and interest rates. The job destruction contributed to reducing real income growth and the deterioration of the labour market eroded household confidence. Moreover, the sharp fall in stock market prices in 2008 and the decrease in house prices reduced household wealth in real terms, against a background of tighter credit conditions. All these factors are leading to a recovery in the household saving rate, which, according to the non-financial accounts of the institutional sectors, increased in 2008 to 13% of disposable income, 2.8 pp more than in 2007, and this trend will foreseeably continue in 2009.

General government final consumption seems to have kept growing substantially in 2009 Q1, albeit more slowly than in the preceding quarter, according to available information on net purchases of goods and services drawn from the State budget outturn.

According to available economic information, investment in capital goods again fell in early 2009 (see Chart 16). Business confidence, as reflected by indicators of industry confidence and of the order book of the capital goods sector, deteriorated further in Q1 as a whole.

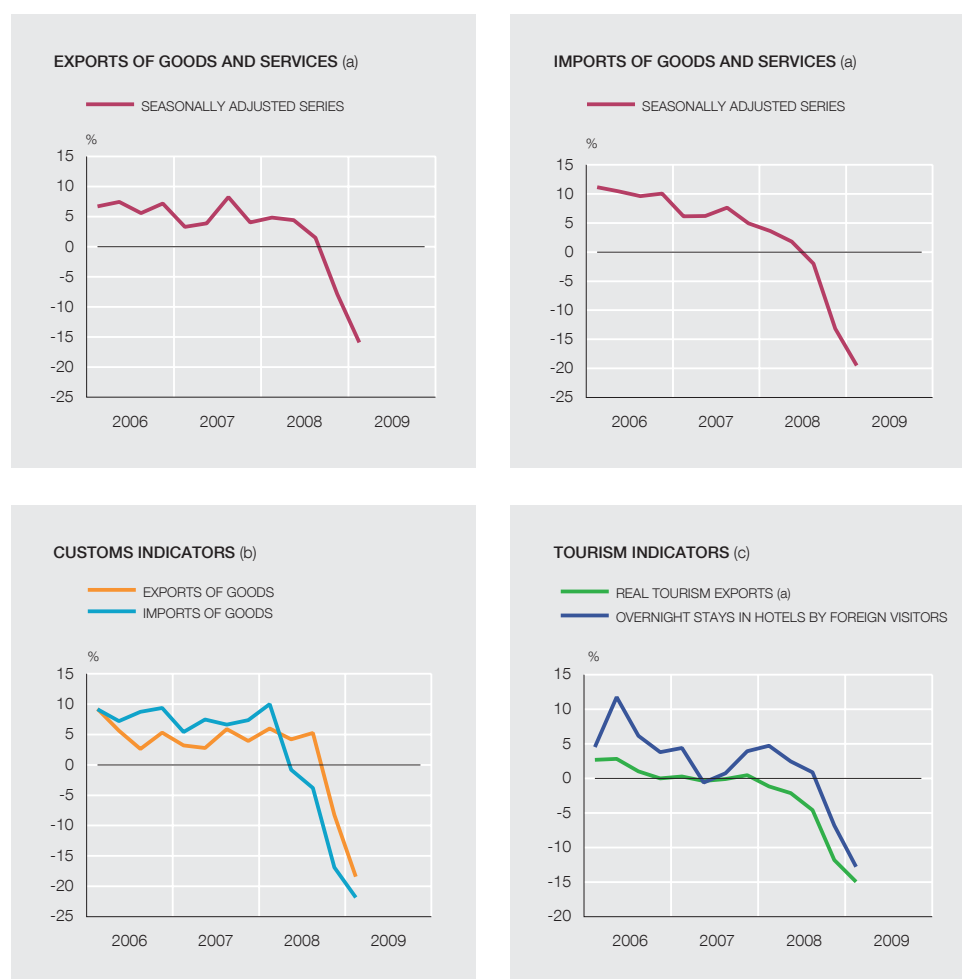
Moreover, the indices of apparent investment in capital goods, although based on as-yet incomplete data, point to a sharp contraction. The fall in national and external demand and the tightening of bank credit conditions, along with the greater difficulty in raising funds by other means, continue to deter new investment projects by non-financial corporations, despite the interest rate cuts. These factors have given rise to a decrease in the sector's net borrowing, which stood at 7.5% of GDP in 2008, down 3.6 pp on 2007, according to the non-financial accounts of the institutional sectors. Also contributing in this respect was firms' higher saving, aided by a less negative contribution of net interest payments and by lower tax disbursements, although this last factor is, in part, of a temporary nature because it is related to the change in the VAT refund schedule.

In regard to total investment in construction, inputs indicators (apparent consumption of cement and domestic production of construction materials) decreased more in January and February than in 2008 Q4. Labour market coincident indicators also tended to be contractionary, with a decrease in the average number of Social Security registrations of nearly 25% year-on-year in 2009 Q1. Lastly, the construction sector confidence indicator compiled by the European Union deteriorated further in the first quarter of the year.

The adjustment of residential investment is estimated to have quickened in the quarter as a result of the significant decline in the number of housing starts in 2008 and the first few months of 2009 and of the completion of residential building work started earlier (see Box 5). Within the total housing starts, government subsidised housing continued to increase and it now accounts for around half of total housing starts. Recently there has been a steeper decline in house sales, according to data on transactions from associations of registrars and notaries public for 2008 Q4, and in the number of mortgages taken out. The demand for housing is being discouraged by the tougher financial conditions, the expectations of price falls and the worsening outlook for household income growth, and foreseeably non-residential construction will contract further in Q1, in step with the decrease in new project approvals in the recent past. Lastly, civil engineering works continued to be held back by the fall in government tendering, although they are expected to pick up again in Q2 when the projects financed by the State Fund for Local Investment start to be executed.

The information available for Q1, as yet incomplete, points to a slight decrease in the contribution of net external demand to GDP growth (down by 0.1 pp to 2.2 pp). This reflects the marked declines in both imports and exports, which, compared with Q4, were somewhat sharper in the case of exports (see Chart 17). The decrease in purchases from the rest of the world is in step with the negative trend shown by investment in capital goods and exports, which are the final demand components with the highest import content, and with the fall-off in industrial production. For their part, exports are being determined by the marked contraction in world trade, which has affected the markets of both the advanced economies (our main customers) and emerging countries.

On Customs data, real goods exports fell off markedly in the first two months of the year (by 22.1%). By product group, exports fell sharply across the board, except in food, where the drop was more moderate. The adjustments were somewhat more sizeable in the European Union markets than those of the rest of the world. The balance of payments figures to January show double-digit decreases in real exports of tourism and non-tourism services. Regarding the former, inbound tourists into Spain and the number of overnight stays in hotels fell appreciably in the period January-February, as did nominal spending by foreign visitors.



SOURCES: INE, Ministerio de Economía y Hacienda and Banco de España.

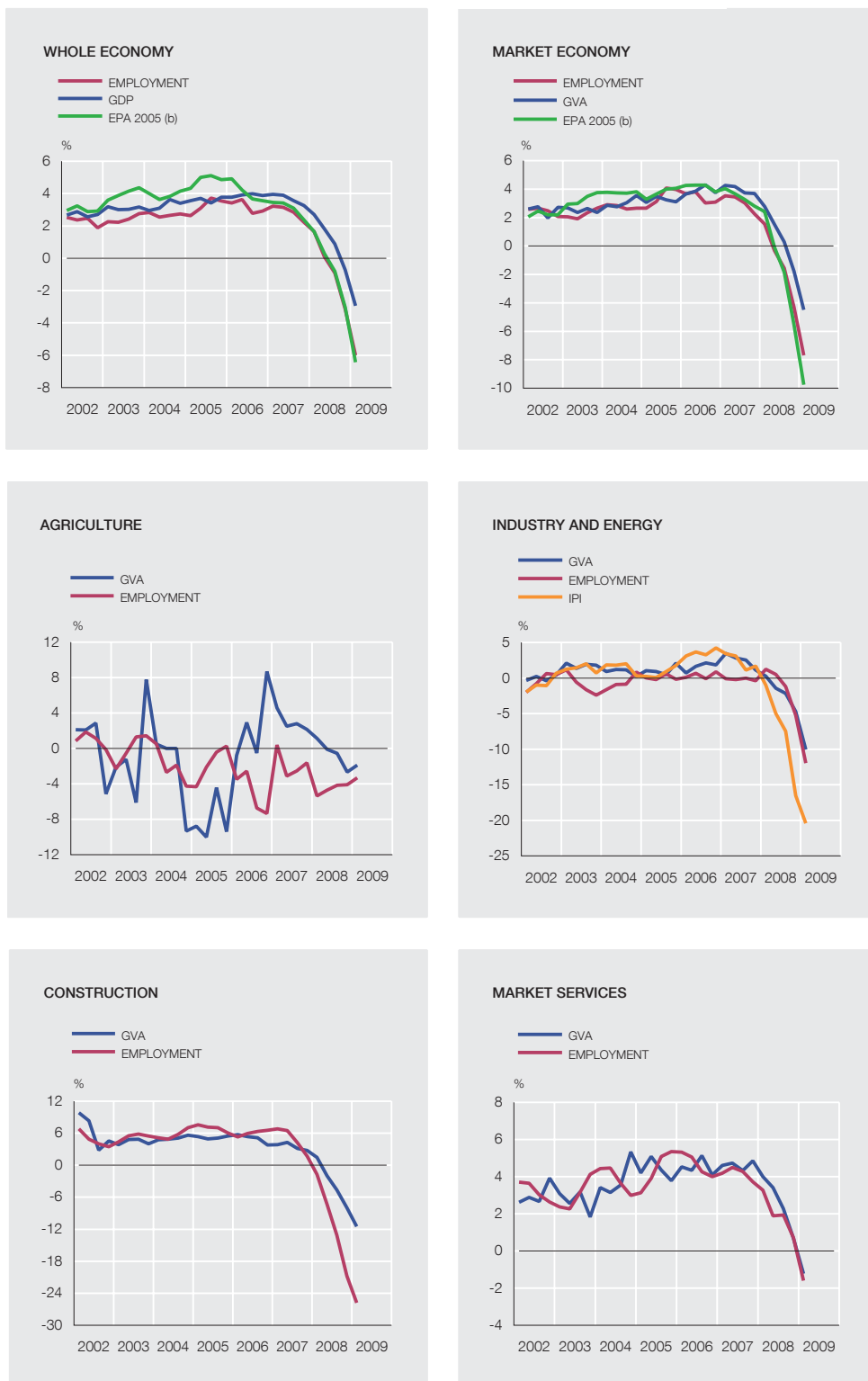
- a. QNA data at constant prices.
- b. Deflated seasonally adjusted series.
- c. Seasonally adjusted series.

Real goods imports also fell off more quickly in 2009 Q1. In this respect, Customs data show that purchases of goods abroad in real terms decreased by 25.1% in the first two months of the year. By product group, the contraction was much sharper in capital and intermediate goods than in consumer goods. Notable among the latter was the much smaller fall, in comparable terms, seen in food (the least sensitive to the cycle), but which was also apparent in other goods. Real imports of services are estimated to have also declined notably faster in Q1, in line with the behaviour of expenditure on non-tourism services and of tourism imports in the balance of payments.

4.2 Output and employment

The year-on-year rate of change of the gross value added of the market economy as a whole decreased notably in Q1, and the quarter-on-quarter rate of contraction of 2.3% was more pronounced than in the closing months of 2008. This loss of vigour affected, to a greater or lesser extent, all market economy productive branches (see Chart 18).

Q1 as a whole will foreseeably show a sharp fall in the year-on-year rate of change of the value added of the industrial branches, which would be consistent with a quarter-on-quarter decline similar to that of 2008 Q4. The year-on-year growth rate of the industrial production index (IPI)



SOURCES: INE, Ministerio de Fomento and Banco de España.

a. Year-on-year percentage rates based on seasonally adjusted series, except gross series in the EPA. Employment in terms of full-time equivalent jobs. For incomplete quarters, the year-on-year rate for the period available within the quarter is taken.

b. Series linked by the DG Economics, Statistics and Research on the basis of the control survey conducted using the methodology applied until 2004 Q4.

again fell in the January-February period, in line with the behaviour of the goods sales of large firms. By product type, the falls were across the board, being particularly sharp in the industries producing capital and non-energy intermediate goods. Labour market indicators, such as the number of Social Security registrations, also continued performing adversely. By contrast, some confidence indicators, such as the manufacturing Purchasing Managers Index, showed certain signs of moderation, albeit within their prevailing pessimistic tone.

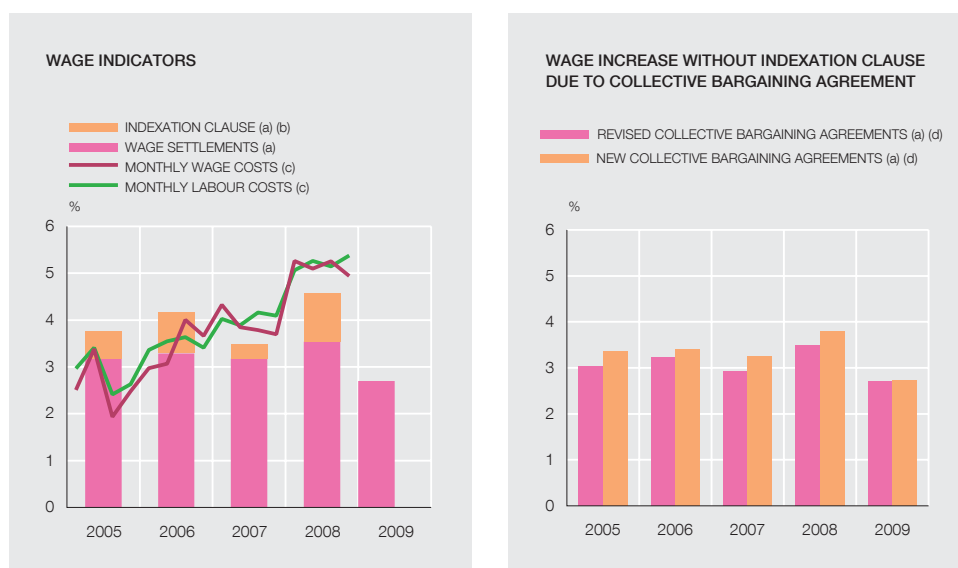
Construction activity continued to deteriorate in the first quarter of the year, as reflected by the main coincident indicators (Social Security registrations, numbers of unemployed, consumption of cement and tax authorities' figures) and leading indicators (number of housing approvals). Activity in the agricultural and fisheries sectors remained contractionary, as reflected by the preliminary estimates of crop areas and yields made by the Ministry for the Environment and the Rural and Marine Environment.

The conjunctural information on the early months of 2009 points to an additional deterioration in the gross value added of market services. Thus Q1 brought sharper falls in the sales of large firms, expressed in real terms and seasonally adjusted, and in their turnovers. The indicators of employment in the sector also worsened with respect to the previous quarter. Thus in the first quarter of the year the number of Social-Security registered employees fell more sharply and the number of unemployed increased appreciably. By contrast, the European Commission's retail confidence indicators for retail trade and the activity index of the PMI for the services sector rose slightly in 2009 Q1. The confidence of the services sector, after having dropped to a record low in January, recovered slowly in the following two months.

The labour market indicators available for the early months of 2009 all show that the pace of job destruction quickened. Specifically, the year-on-year fall in Social Security registrations in the first quarter was, on average, 5.9%, which was 2.5 pp less than in the previous quarter. Lastly, the Spanish Labour Force Survey for Q1 indicates a year-on-year fall in employment of -6.4%, down 3.4 pp on the previous period. The decrease in employment seems to have affected all sectors of the market economy, particularly construction (-25.9%) and industry (-12.5%).

On Spanish Labour Force Survey data, the fall in employment affected both dependent employees, with a fall of 5.8%, and the self-employed (-9.4%). Job destruction was, for the first time, more pronounced among foreign workers (-9.3%), although employment in Spanish nationals also fell sharply (-5.9%). As regards contract duration, the year-on-year rate of decline in temporary wage-earners increased to -20.6% and this group remained at the forefront of the adjustment in employment, while permanent employment growth remained practically at zero (0.6%). As a result, the temporary employment ratio stood at 25.4%, nearly 5 pp less than a year earlier. Lastly, part-time hires decreased by 1.1%, which was less than the drop in full-time hires (-7.2%), and thus, as in the last few quarters, the part-time employment ratio rose, this time to 12.7%, against 12% a year earlier.

The growth rate of the labour force slowed to 2.3% in 2009 Q1 as a result of the deceleration of the population above 16 years of age, which increased by 1% (0.2 pp less than in the previous quarter) and of a year-on-year growth of the participation rate (0.8 pp) somewhat lower than in the last few quarters. In terms of the breakdown by gender, the increase in the labour force was due mainly to women (4.6%), since in the case of men the rise was more moderate (0.7%). Specifically, the female participation rate rose by 1.8 pp in year-on-year terms to 51.5%, while the male rate decreased slightly (-0.1 pp). By nationality, the growth rate of foreign nationals in the workforce slowed to 8.1%, mainly as a result of smaller immigrant inflows



SOURCES: INE and Ministerio de Trabajo e Inmigración.

- The last year with information of collective bargaining agreements until March 2009.
- Previous year's indexation clause.
- ETCL (quarterly labour costs survey). Year-on-year rates of change.
- Revised: collective bargaining agreements with economic effects in the year but which were signed in previous years and are in force for more than one year. New: collective bargaining agreements with economic effects in the year, this being the first or only year they are in force.

(6.2%, against 8.4% in the previous quarter). Spanish nationals in the workforce grew by 1.3% (1.5% in Q1).

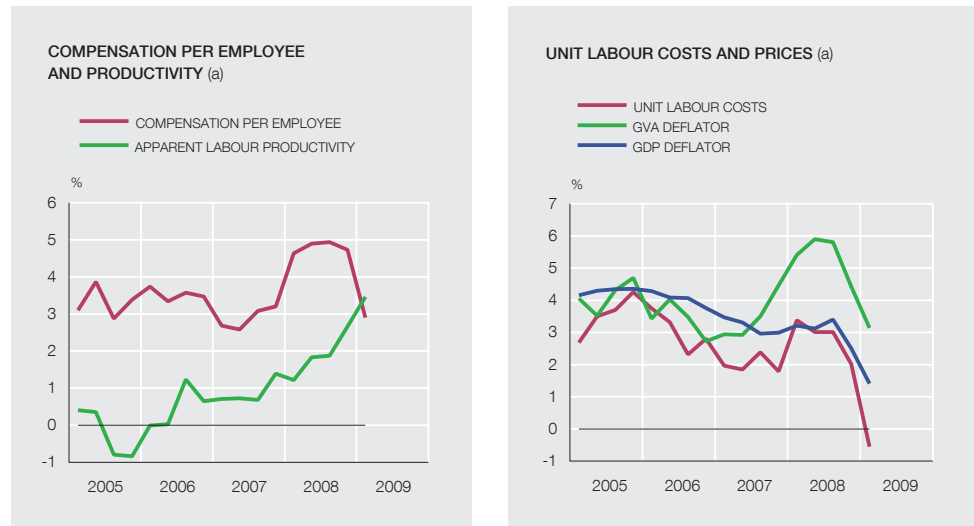
Finally, the sharp adjustment in employment, combined with the persisting dynamism of the labour force, resulted in marked growth in unemployment in the first quarter of the year of the order of 800,000 people compared with the previous quarter, bringing the total to more than 4 million unemployed. This raised the unemployment rate to 17.4%, up 3.5 pp on the previous quarter and nearly 8 pp higher than at the beginning of 2008.

4.3 Costs and prices

The information available on collective bargaining agreements registered to March 2009 suggests that the wage settlements this year have grown less than in 2008, with a wage increase of 2.7% for the 6.2 million workers covered by multi-year settlements signed in previous years. This figure is nearly 1 pp less than that agreed in 2008. Although the number of newly signed agreements is still small, so far they have not shown signs of sufficient adaptation to the cyclical situation. Moreover, it is estimated that the indexation clauses will not have effects on wage costs in 2009, given that inflation fell to 1.4% at the end-2008, which is below the threshold of 2% above which these clauses tend to apply.

Consequently, owing to the smaller wage settlements and to the absence of inflation deviation payments, 2009 Q1 will presumably see a decrease in the growth rate of compensation per employee. That said, it seems that wages will increase at a much higher rate than consumer prices. This would mean sharp real wage growth, despite the recession. However, the behaviour of nominal wages, combined with the estimated rise in productivity, will foreseeably lead to a deceleration in unit labour costs.

It is estimated that the rate of change of the GDP deflator also decreased in 2009 Q1, despite the deceleration of import prices, which were strongly affected by the drop in oil prices. The



SOURCES: INE and Banco de España.

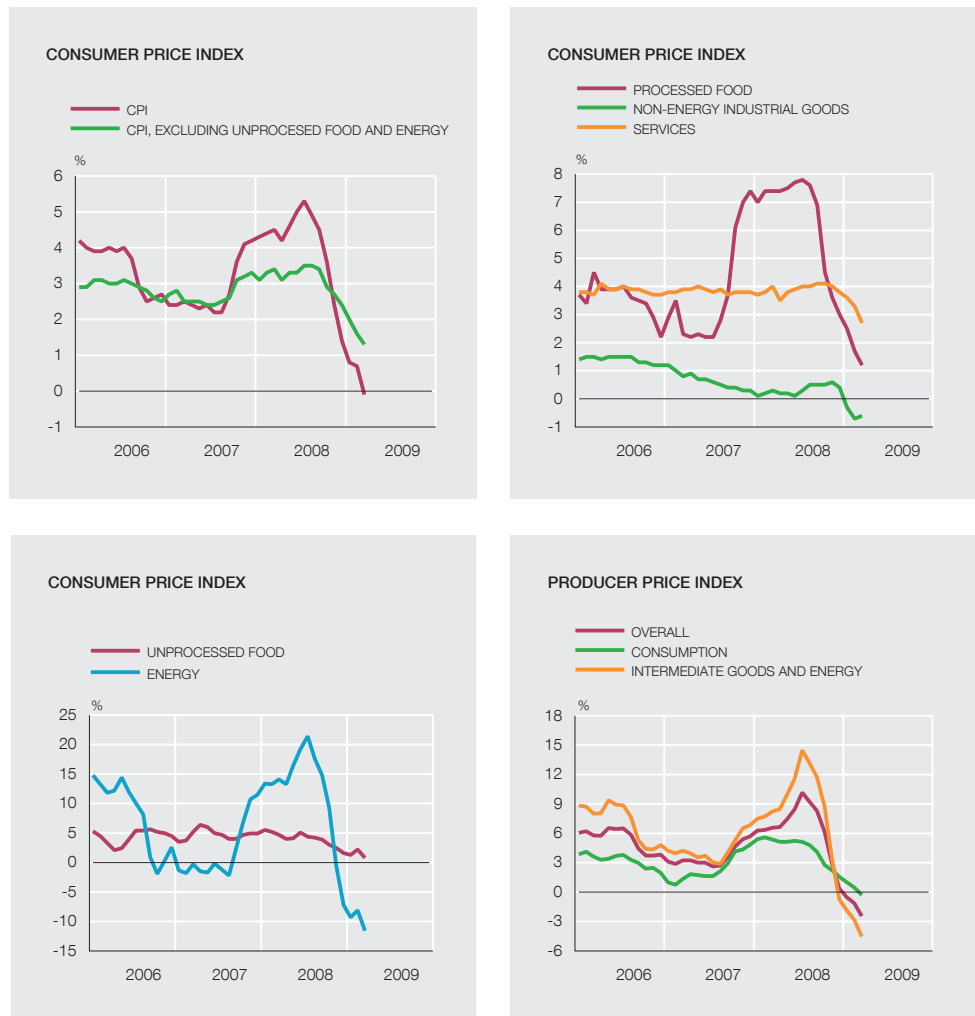
a. Year-on-year percentage change based on QNA seasonally adjusted series.

deflators of the various components of national demand grew more slowly than in the previous quarter. This was particularly so for residential investment (its deflator, against a background of falling house prices, showed negative growth) and for private consumption.

The growth rate of the main consumer price indicators continued to slow in the early months of 2009. Thus the year-on-year rate of change of the CPI was negative (-0.1%) in March for the first time since 1952, standing 1.5 pp below the figure for December 2008 (see Chart 21). The CPI excluding unprocessed food and energy – which historically has shown little sensitivity to changes in the economic cyclical, and particularly so in the case of services – increased in March by 1.3%, 1.1 pp less than the rise at end-2008. The deceleration extended to all components, and non-energy industrial goods even showed negative rates of change, despite price increases in domestically produced goods and in imported goods of this type. The rate of change of energy prices (11.6% in March) represented a negative contribution of 1.3 pp to the overall index. This fall can be explained by a base effect as a result of the large increases a year ago, a factor which prevailed over the fact that oil prices rose somewhat more than \$6 from December 2008 to \$46.8 per barrel in March on average, pushing the price of oil-related products upward. Unprocessed food prices also moderated.

Price adjustments in Spain are proving to be much sharper than in the euro area, so the inflation differential (as measured by the harmonised index of consumer prices – HICP) has been favourable to Spain for the fourth month running, standing at 7 pp in March, an unprecedented occurrence since the inception of the euro area. All the components showed rates of change below those of the euro area, except that of services, although this has decreased substantially since December, and, accordingly, the core inflation differential has been negative in the last two months.

The growth rate of the producer price index decreased to -2.4% in March. The moderation affected its various components, although it weighed most heavily on the prices of intermediate goods and energy products. In the euro area as a whole, the growth rate of producer prices slowed in the first two months of the year to a rate of -1.8%, which was a somewhat sharper deceleration than in Spain.



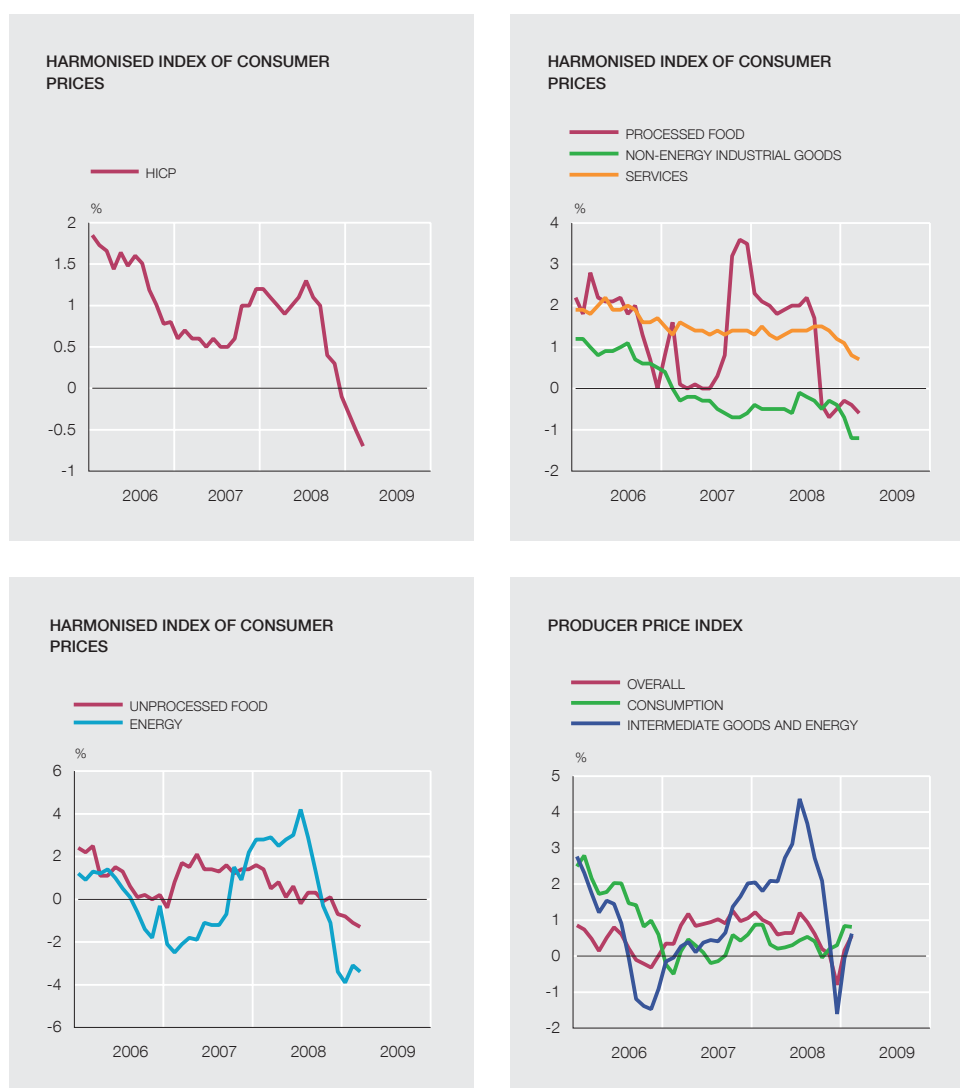
SOURCE: INE.

a. Twelve-month percentage change based on the original series.

4.4 The State budget

According to the National Accounts methodology, the figures published on the State budget outturn show a substantial deterioration from a surplus of €9,466 million (0.9% of GDP) in February 2008 to a surplus of €5,325 million (0.5% of GDP) in the same period of 2009. This was basically due to a fall of 9.5% in resources, as against an increase of 5.3% in uses.

The cash-basis results to March show a deficit of €11,345 million in the State budget outturn, compared with a surplus of €1,272 million in the same period of 2008 (see Table 3). In these initial months, revenue decreased by 18.1%, while State expenditure increased by 15.5%. It should be kept in mind, however, that the figures for the early months of the year are very erratic and hardly representative of the behaviour of the balance in the ensuing months. Despite this, the data point to an additional deterioration in the budget with respect to the previous year, to which certain measures with budget effects will contribute still further. Among these, mention may be made of the inclusion in personal income tax withholdings of the housing deduction for certain taxpayers and the monthly VAT refunds, which will reduce net revenue, while the transfers of amounts owed to the State Fund for Local Investment will add to expenditure.



SOURCES: Eurostat and Banco de España.

a. Twelve-month percentage change based on the original series.

For the description of revenue, information is available on total takings under the main taxes, both for the portion assigned to the State and that relating to the ordinary-regime regional and local governments. According to this information, revenue declined by 11.9% in Q1 compared with the same period a year earlier, due to the weakness of tax receipts. In direct taxes, however, this weakness is influenced by the differential impact on personal income tax of the up to €400 deduction in these initial months of 2009 (without any equivalent in the corresponding months of the previous year), which will only be offset, in part, in the second half of the year. However, the impact of the economic crisis was reflected in withholdings on earned income and, above all, in withholdings on investment fund gains, which decreased by 45.6%. Notable among the indirect taxes is the fall in VAT, down by -26.2% with respect to the first quarter of the previous year. In this case, the figures are affected not only by the fall in consumption and in real estate transactions, but also by the sharp increase in refunds and by the fall in imports from non-EU countries, which caused a decrease of 31.4% year-on-year in VAT on the latter. Excise duties decreased by 5.4%. The items aggregated under the “Other State revenue” heading showed relatively high growth due to the public debt issue premiums and the receipt

Beginning in the late 1990s, numerous industrialised economies saw property booms which led to high growth of house prices, expansion of the construction sector and increased household debt. In the present circumstances, where the international financial crisis has imposed a need for more drastic correction of the excesses accumulated in this sector, it is of interest to examine to what extent the different workings of the real estate markets and some of the features of those booms may lead to different adjustment paths. In Europe, the two main economies affected by this phenomenon, and which are a good example for illustrating it, are probably Spain and the United Kingdom. This Box presents a number of stylised features of the processes of correction taking place in the real estate sectors of the two countries.

In the expansionary phase, house prices followed a similar path in the United Kingdom and Spain, and these countries were among the European markets with the highest growth in that stage. In real terms, from 1997 to 2007 average house prices increased by 120% in Spain, against 140% in the United Kingdom, while average house prices in euro area markets rose by only 40% (see Chart 1). In 2008 and early 2009, the adjustment of the sector, together with the financial crisis, brought a sharp correction in the prices of residential assets. This correction is more severe in the United Kingdom than in Spain, although price comparisons should always be regarded with caution, given the methodological differences in price estimates. House prices in the British market have decreased in real terms in the past year, and the fall in real terms amounted to around 20% year-on-year in 2008 Q4. In Spain, according to Ministry of Housing statistics on appraisals, house prices in real terms fell by 5.7% year-on-year in 2008 Q4 and by 7.3% in 2009 Q1.

The behaviour of house prices reflects differing combinations of residential asset supply and demand in the two countries. Among the demand factors, demographic dynamism has been a salient feature of the Spanish economy, while population growth in the United Kingdom, although it has picked up in recent years, has been rather more modest. In addition, although in both countries short-term real interest rates followed a downward path in the expansionary phase and variable-rate loans predominated, this factor acted more strongly in Spain as a result of this country's entry into the euro area. The new regime of macroeconomic stability guaranteed by the euro area fuelled, moreover, expectations of improved income growth in Spain, which were probably not so strong in the United Kingdom. Other demand factors operated more similarly in the two countries. Thus both economies have seen significant changes in population structure which have raised demand for housing, basically due to the rising number of single-person households. Additionally, the increase in residential demand was made easier in both countries by the ready access to credit, partly linked in the United Kingdom to the extensive liberalisation of these markets and, in Spain, to the strong competition and to innovation in the mortgage segment. This ready access to credit led to rapid growth in household debt ratios in both economies, although in the United Kingdom this ratio reached a higher level (see Table 1).

In real estate booms, the initial rigidity of supply makes it usual for the rising demand to put upward pressure on prices. However, the

response to the supply of new houses depends on the characteristics of each country's housing market. Hence, in the latest expansionary cycle, the behaviour of residential investment is clearly different in Spain and the United Kingdom. Specifically, in 2007, i.e. at the peak of the cycle, the ratio of residential investment to GDP in Spain was 7.5%, much higher than in the United Kingdom (see Chart 2). In fact, the main distinguishing feature of the latest housing cycle in Spain is that the price rise was accompanied by a strong increase in supply, leading to an unprecedented level of activity in the sector. By contrast, the step-up in real estate activity in the British market was rather more limited. The reason for this lesser response can be attributed, in part, to UK urban planning and, more specifically, to constraints on the supply of land. These differences in the response of supply are reflected in the National Accounts figures. Thus, whereas in Spain the housing sector contributed around 0.5 pp to GDP growth on average in the period 1998-2007, its contribution in the United Kingdom was significantly smaller (0.1 pp) (see Chart 3).

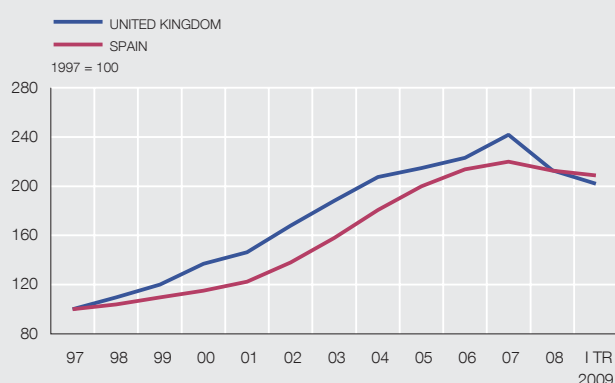
The process of adjustment in Spain and the United Kingdom is shaped by these characteristics of the expansionary phase. In this respect, the correction of the housing sector in terms of quantities is proving to be much more significant in Spain than in the United Kingdom. According to National Accounts figures for 2008 and the projections for the coming years, the expected fall in residential investment in Spain will reduce the ratio of housing investment to GDP until 2010, in real terms, by more than 3 pp below the high reached in 2006-2007. Given that the ratio of housing investment to GDP was only 3.4% in the United Kingdom in 2007, the sector's lower activity will mean a smaller effect on GDP and employment growth in this country.

Having said this, the consequences of the real estate adjustment are not limited to the direct effects of the resizing of the sector, but also act through other channels. Particularly notable among the indirect effects are those relating to real estate wealth, since this is a factor which substantially affects household spending and saving decisions. Both economies have a high percentage of owner-occupancy in the total stock of houses, so wealth effects could be more significant than in other countries where the rental market is more developed. The initial evidence is that the price adjustment is proving to be sharper in the United Kingdom than in Spain, so that loss of wealth may have affected household spending more in the United Kingdom. Moreover, it is common in the United Kingdom to use the unrealised capital gains associated with house price rises in order to obtain consumer loans with mortgage security (see Chart 4). Private consumption during the boom was underpinned by this mechanism (also called "mortgage equity withdrawal"), while in the current circumstances it has been more adversely affected as a consequence of the lower equity release. The use of these instruments has put some households in a comparatively more vulnerable situation from the financial standpoint, which may constrain their spending decisions. This means of borrowing has scarcely been used in Spain, so this channel is not producing an additional contraction in household spending in the Spanish economy.

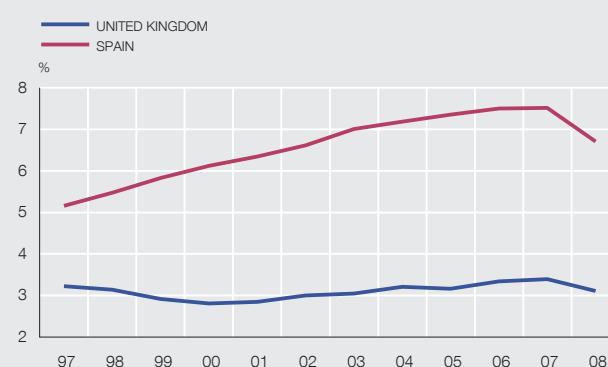
In regard to the adjustment of real estate activity, the strong increase in supply in the latter years of the boom and the sudden contraction of demand are leading to the emergence of a substantial stock of unsold houses which will have to be absorbed before new real estate investment projects can be undertaken. However, the decrease in prices and in mortgage interest rates will help to make houses more affordable in the coming years, thereby facilitating this absorption. Also, although the population is not showing the dynamism of the

past decade, there still persist some demand factors (both demographic and those relating to Spain's status as a tourist destination) which shore up housing investment to some extent. In the United Kingdom, the over-supply was unquestionably smaller and there was less need for absorption of excess stock. By contrast, the adjustment depends largely on prices, which may give rise to a sharper increase in households' saving rate and to less buoyant investment by them, thereby hampering the recovery of activity.

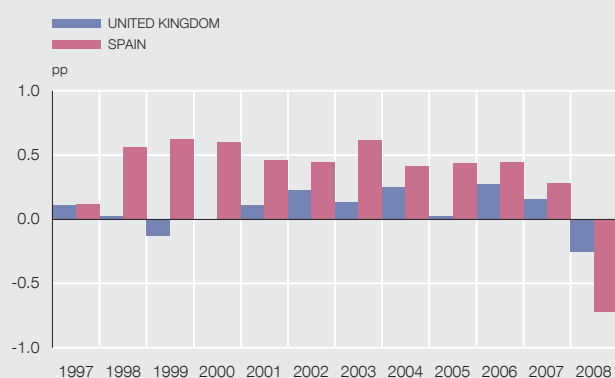
1 REAL HOUSE PRICES



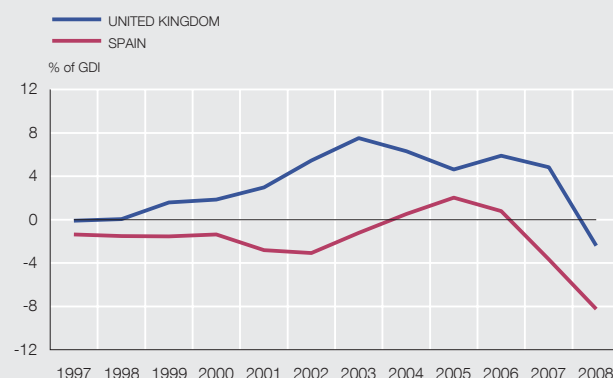
2 RATIO OF REAL HOUSING INVESTMENT TO GDP



3 CONTRIBUTION OF RESIDENTIAL INVESTMENT TO GDP GROWTH



4 MORTGAGE EQUITY WITHDRAWAL (a)



SOURCES: INE, Ministerio de Vivienda, Bank of England, Eurostat and Banco de España.

a. Calculated as the difference between lending for house purchase and nominal housing investment by households.

1 STYLISED FACTS

	United Kingdom	Spain
Weight of housing investment in GDP (%)	3.4	7.5
Cumulative change since 1998 (percentage points)	0.3	2.0
Number of housing starts (2005-2007 average) (thousands)	225	697
Increase in population (2005-2007 average) (thousands)	316	727
Percentage of owner-occupied houses (2000) (%)	71.0	85.0
Contribution of residential investment to GDP (1998-2007 average) (percentage points)	0.1	0.5
Contribution of construction to employment (1998-2007 average) (percentage points)	0.2	0.8
Household debt ratio (2007) (% of GDI)	160.2	130.9

SOURCES: INE, Ministerio de Vivienda, Bank of England, Eurostat and Banco de España.

EUR m and %

	Outturn 2008	Percentage change 2008/2007	Outturn projection 2009	Percentage change 2009/2008	Outturn		
					2008 JAN-MAR	2009 JAN-MAR	Percentage change
					1	2	3
1 REVENUE	129,335	-19.1	141,110	9.1	38,181	31,269	-18.1
Direct taxes	74,096	-23.6	77,041	4.0	17,516	13,594	-22.4
<i>Personal income tax</i>	43,413	-10.7	43,167	-0.6	15,112	11,678	-22.7
<i>Corporate income tax</i>	27,301	-39.1	30,085	10.2	1,511	1,023	-32.3
<i>Other (a)</i>	3,382	-4.2	3,789	12.1	893	894	0.1
Indirect taxes	39,229	-19.0	50,202	28.0	17,371	12,567	-27.7
VAT	24,923	-26.2	35,531	42.6	13,926	9,559	-31.4
<i>Excise duties</i>	11,220	-2.2	11,253	0.3	2,623	2,304	-12.2
<i>Other (b)</i>	3,086	-4.3	3,418	10.8	822	703	-14.4
Other net revenue (c)	16,011	11.1	13,867	-13.4	3,294	5,108	55.1
2 EXPENDITURE	148,082	6.0	157,904	6.6	36,909	42,614	15.5
Wages and salaries	25,257	6.7	26,848	6.3	5,354	5,635	5.2
Goods and services	4,551	2.2	3,502	-23.1	953	905	-5.1
Interest payments	15,929	9.6	17,424	9.4	6,532	6,151	-5.8
Current transfers	82,765	6.5	85,754	3.6	19,558	22,143	13.2
Contingency fund and other unforeseen expenditure	—	—	3,251	—	—	—	—
Investment	10,654	5.4	10,408	-2.3	2,578	2,787	8.1
Capital transfers	8,927	-3.5	10,717	20.1	1,933	4,994	158.3
3 CASH-BASIS BALANCE (3 = 1 - 2)	-18,747	—	-16,794	—	1,272	-11,345	—
MEMORANDUM ITEM: TOTAL TAXES (State plus share of regional and local governments)							
Personal income tax	71,341	-1.8	77,444	8.6	21,033	19,002	-9.7
VAT	48,015	-14.0	53,323	11.1	19,335	14,274	-26.2
Excise duties	19,570	-1.1	20,461	4.6	4,805	4,546	-5.4

SOURCE: Ministerio de Economía y Hacienda.

- a. Includes revenue from the tax on the income of non-residents.
b. Includes taxes on insurance premiums and tariffs.
c. Includes charges and other revenues, current transfers, profits and dividends, capital transfers and other unclassified transactions.

of guarantee fees by the Fund for the Acquisition of Financial Assets (Royal Decree-Law 7/2008), which offset the falls in funds received from the European Union, especially the ERDF.

State cash-basis expenditure increased by 15.5%, notably above the budget forecast for the year as a whole (6.6%). Specifically, with the exceptions of personnel costs and interest payments, the other items showed higher growth rates than envisaged in the budget. Particularly notable was the strong growth in current transfers, mainly to other general government, which should decelerate in the coming months to rates in line with the budget. Also worthy of mention is the large increase in capital transfers owing to those made to local government in connection with the State Fund for Local Investment.

As regards the Social Security system, information is available on the number of social security registrations for the early months of the year, which kept falling in Q1, with a drop of 6.5% at end-March, and on the number of contributory pensions, which increased by 1.6% in that same period, in line with the increases seen in the closing months of the previous year, al-

EUR m		JANUARY		RATE OF CHANGE 09/08 (b)
		2008	2009	
CREDITS	Current account	29,258	23,527	-19.6
	<i>Goods</i>	15,374	11,444	-25.6
	<i>Services</i>	7,309	6,241	-14.6
	— Tourism	2,756	2,389	-13.3
	— Other services	4,553	3,852	-15.4
	<i>Income</i>	4,964	4,249	-14.4
	<i>Current transfers</i>	1,611	1,593	-1.1
	Capital account	1,372	451	-67.1
	Current + capital accounts	30,630	23,978	-21.7
	DEBITS	Current account	41,289	30,112
<i>Goods</i>		23,991	15,560	-35.1
<i>Services</i>		5,914	4,942	-16.4
— Tourism		1,112	939	-15.6
— Other services		4,801	4,003	-16.6
<i>Income</i>		8,487	7,508	-11.5
<i>Current transfers</i>		2,897	2,102	-27.5
Capital account		134	398	197.5
Current + capital accounts		41,423	30,510	-26.3
BALANCES		Current account	-12,031	-6,584
	<i>Goods</i>	-8,616	-4,116	4,500
	<i>Services</i>	1,395	1,299	-96
	— Tourism	1,644	1,451	-193
	— Other services	-248	-152	97
	<i>Income</i>	-3,524	-3,259	265
	<i>Current transfers</i>	-1,286	-508	778
	Capital account	1,238	53	-1,186
	Current + capital accounts	-10,793	-6,532	4,261

SOURCE: Banco de España.

a. Provisional data.

b. Absolute changes for balances.

though somewhat above the average growth for 2008. According to National Public Employment Service figures, the growth of expenditure on unemployment benefits continued to accelerate in Q1, showing an increase of 65.4%. This acceleration reflects the growing rate of increase in the number of beneficiaries of these benefits, up 66.9% to February.

4.5 Balance of payments

Overall balance on current and capital account was a deficit of €6,532 million in January 2009, down 39% on the same month a year earlier. The current account deficit narrowed by 45% to €6,584 million. The main current account balances showing a deficit were partially corrected in January, including most notably the sharp decrease in the trade balance and, to a lesser extent, the decrease in current transfers and income. By contrast, the surplus on the services balance fell off moderately.

The deficit on the trade balance decreased by €4,500 million in January with respect to the same month a year earlier to stand a €4,160 million. This was a fall of 52%, a significantly higher rate of decrease than in 2008 Q4. Exports and, to a greater extent, imports fell more rapidly, against a backdrop of improvement in the real terms of trade. The improvement in the

trade deficit reflected both the smaller energy bill and the less negative balance of other goods.

The deficit of €1,299 million on the services balance was 6.9% less than in January 2008. This was a result of the 12% decrease in the surplus on the tourism balance to €1,451 million, which offset the improvement in the deficit on other services. Nominal tourism receipts decreased by 13.3% in January 2009, making for a steeper fall than that of the closing months of 2008, while tourism expenditure was down by 15.6%. The decrease in expenditure on other services outstripped that in receipts (–17% and –15%, respectively).

The deficit on the income balance improved to €3,259 million, while the deficit of €508 million on the current transfers balance was less than that recorded in the same month a year earlier, with a fall in migrant remittance payments. Lastly, the surplus on capital account decreased to €53 million in January 2009 due to the lower receipts by general government, basically of ERDF structural funds.

Financial developments

5.1 Overview

The financial crisis and the progressive weakening of the economy and deterioration in growth prospects continued to affect the financial markets, in Spain and abroad, in 2009 Q1. Thus share prices continued to fall in January and February, especially in the case of financial sector stocks which lost slightly more than 20% of their value, while volatility also rose (see Chart 23). However, the situation improved in March and the first weeks of April, so that by 24 April the IBEX 35 was down 3.3% from its end-2008 level, a marginally smaller fall than those recorded by the Euro Stoxx 50 index of European companies (5.4%) and the S&P 500 for US companies (4.1%).

The downward revision of key ECB interest rate expectations, together with the decline in interbank risk premia, led to a further decrease in 1-year EURIBOR, to 1.76% as at 24 April, continuing its downward trend that began in mid-October. Nonetheless, despite this decrease, the spread over the cost of secured financing transactions (repos) at 1-year remained wide (86 bp).

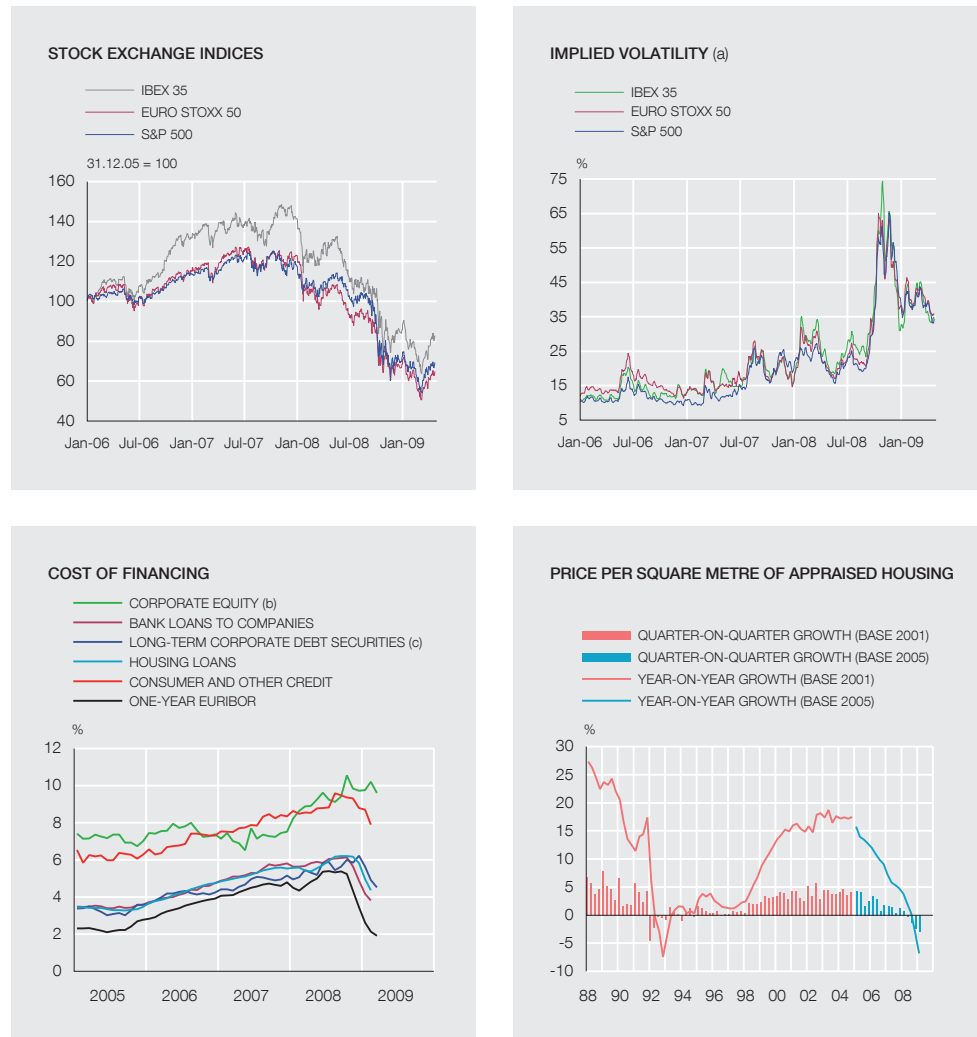
The cut seen and expected in official interest rates prompted a decline in government debt yields at the shortest maturities. Thus, as at 24 April, Treasury bill yields were 78 bp below end-2008 levels. By contrast, 10-year bond yields rose by almost 20 bp, to around 4%. As German bund yields rose by slightly more, the spread between the two narrowed somewhat (by 11 bp) in the period overall, to 80 bp, although in February it reached more than 120 bp. Average credit risk premia at Spanish non-financial corporations listed on derivatives markets fell substantially (by almost 150 bp), after hitting all-time highs at the end of 2008.

In the property market, the latest data published by the Ministry of Housing, corresponding to 2009 Q1, show that the price of unsubsidised housing fell by 3% in the period, leading to a reduction in the year-on-year growth rate from -3.2% in 2008 to -6.8% in March 2009.

The latest figures on the cost of bank lending to households and firms, for February, record a significant decline in comparison with end-2008 levels, in line with the substantial drop in market yields since November. Nevertheless, the decline in interbank rates in recent months was not fully passed through to bank lending rates, meaning that the spreads between the two widened, especially in the higher risk segments. Traditionally, there is some delay before changes in market yields are passed through to bank lending rates, but in this case at least part of the recent spread widening may possibly not be temporary, given the higher risk perceived by the financial institutions in lending transactions and the higher premia they need to pay to finance themselves. The cost of both short- and long-term corporate fixed-income issuance and the cost of equity also fell in 2009 Q1. The April Bank Lending Survey (BLS) shows that credit institutions tightened their lending standards again in the opening months of 2009, although significantly less so than in previous quarters.¹ The latest data available, in this case for January, on other lending conditions (term, security required) also reflect less favourable conditions for borrowers. Accordingly, it seems that firms and households would have found it increasingly difficult to raise funds, even though any financing obtained would have been at a lower interest rate.

In this context, private-sector debt continued to move on a slowing path in 2009 Q1. The year-on-year rate of growth of household financing stood at 3% in February, down slightly more

1. See the article entitled "Encuesta sobre Préstamos Bancarios en España: abril de 2009", by Jorge Martínez Pagés, published in the Boletín Económico, Banco de España, April 2009, for more details.



SOURCES: Bloomberg, Credit Trade, Datastream, MSCI Blue Book, Ministerio de Vivienda and Banco de España.

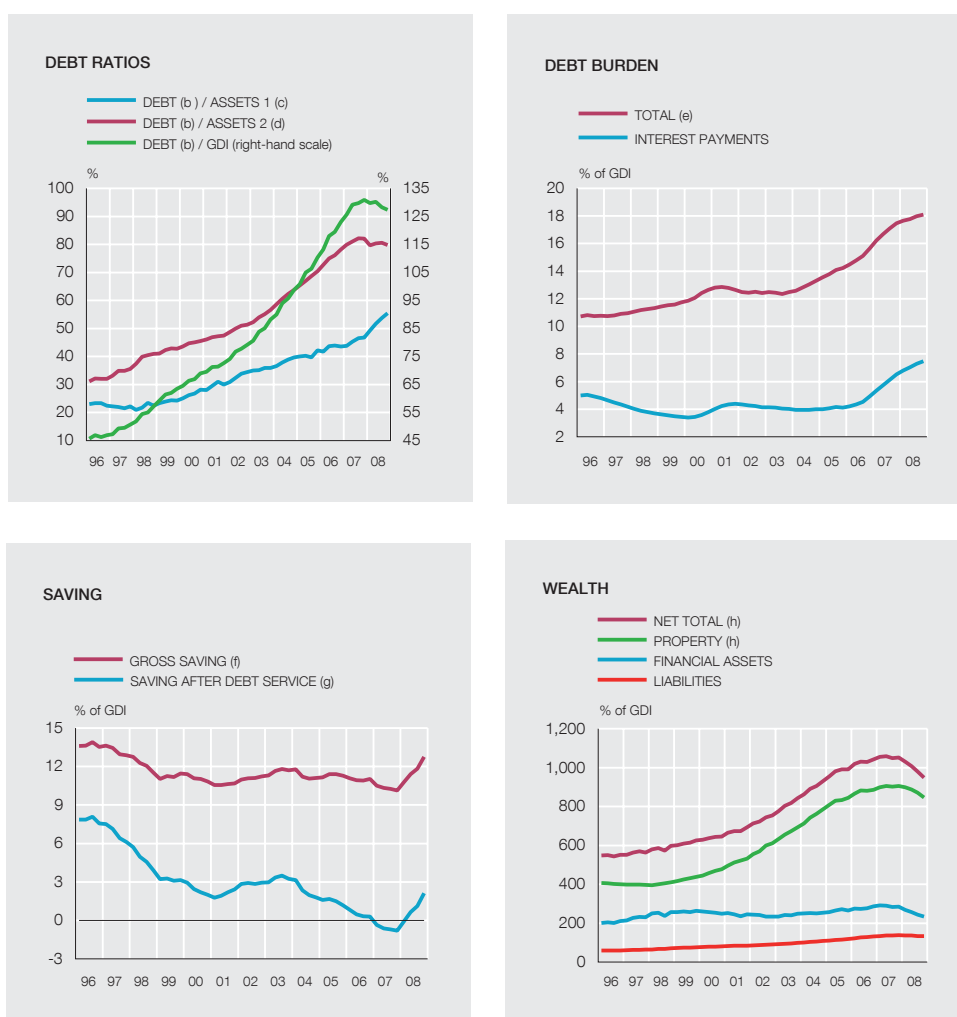
a. Five-day moving averages.

b. The cost of equity is based on a three-stage Gordon dividend discount model.

c. The cost of market-based long-term debt is calculated as the sum of the weighted average 5-year CDS premium for Spanish non-financial corporations and the 5-year euro swap rate.

than 1 pp from December, as a result of the lower momentum in housing loans and consumer and other credit, while the decrease in the rate of growth of loans to corporations was slightly less (0.6 pp), taking it just under 7%. The latest information on lending by purpose, relating to December 2008, shows a general deceleration across all the productive branches, albeit most pronounced in construction and real estate services; in fact in construction the rate of growth turned negative (-1%), while in non-real estate services and industry it moderated somewhat but remains high.

The deceleration in household borrowing helped bring down the sector's ratio of debt to gross disposable income (GDI) again in 2008 Q4 (see Chart 24). Despite this decrease, interest payments rose slightly in annual terms, as the average cost of on-balance-sheet liabilities was still higher than during the same period of 2007. Household net wealth relative to income decreased, due to the decline in value of both its components (property and financial assets). Household saving rates, after debt servicing, continued along the path of recovery. In line with these developments, for the first time in recent years, net financial transactions posted a

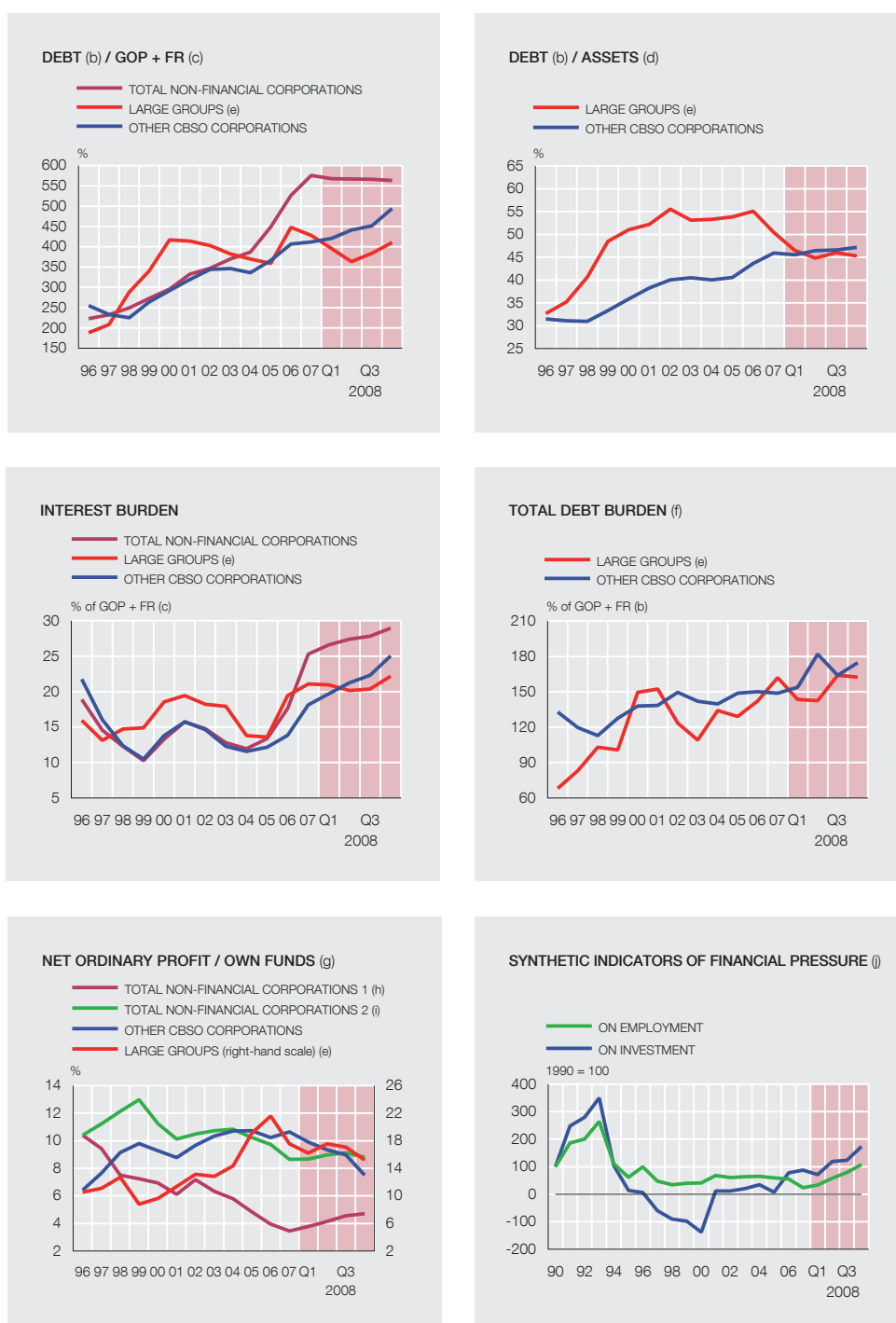


SOURCE: Banco de España.

- a. From 2000, the sectoral National Accounts data correspond to the CNE base 2000. For prior periods, an estimate consistent with this base is used.
- b. Includes bank credit and off-balance-sheet securitised loans.
- c. Assets 1 = Total financial assets less "Other".
- d. Assets 2 = Assets 1 less shares less holdings in mutual funds.
- e. Estimated interest payments plus debt repayments.
- f. Balance of households' use of disposable income account.
- g. Gross saving less estimated debt repayments.
- h. Calculated on the basis of the estimated changes in the stock of housing, in the average area per house and in the price per square metre.

credit balance (albeit close to zero) at the end of 2008. The latest advance data indicate that these trends continued in the opening months of 2009.

In the case of corporations, the debt ratio fell slightly in 2008 Q4, while the debt burden ratio rose again (see Chart 25). The most recent data suggest that both ratios will have fallen in the opening months of 2009. The Financial Accounts reflect a decline in firms' borrowing requirements in the last part of 2008, down to around 7% of GDP in cumulative annual terms in December, 2.5 pp below the September figure. Moreover, despite the downturn, on the National Accounts estimate, gross operating surplus (GOS) in the sector rose by almost 10% in 2008, implying no drop in return on equity. Nevertheless, other data sources based on company accounts signal a less dynamic profit performance. Thus, for firms reporting to the quarterly survey of the Central Balance Sheet Data Office (CBQ), in which large firms predominate,



SOURCE: Banco de España.

a. Based on CBSO annual and quarterly survey data, except in the case of the "Total non-financial corporations" series which is based on National Accounts (CNE and FASE). From 2000, the sector's income corresponds to the CNE base 2000. For prior periods, an estimate consistent with this base is used.

b. Interest-bearing borrowed funds.

c. Gross operating profit plus financial revenue.

d. Defined as total inflation-adjusted assets less non-interest-bearing liabilities.

e. Aggregate of all corporations reporting to the CBSO that belong to the Endesa, Iberdrola, Repsol and Telefonica groups.

Adjusted for intra-group financing to avoid double-counting.

f. Includes interest plus interest-bearing short-term debt.

g. For total non-financial corporations, NOP = GOS plus interest and dividends received less interest paid less fixed capital consumption.

h. Equity at market price.

i. Equity calculated by accumulating flows as from 1996 balance.

j. Indicators estimated drawing on the CBA and CBQ surveys. A figure above (below) 100 denotes more (less) financial pressure than in the base year.

NET FINANCIAL TRANSACTIONS
Four-quarter data

TABLE 6

% of GDP	2003	2004	2005	2006	2007		2008		
					Q4	Q1	Q2	Q3	Q4
National economy	-2.9	-4.8	-6.5	-8.4	-9.7	-10.0	-10.0	-9.6	-9.1
Non-financial corporations, households and NPISHs	-3.8	-5.1	-8.4	-11.0	-13.8	-13.7	-12.3	-9.9	-6.9
<i>Non-financial corporations</i>	-3.9	-4.5	-7.1	-9.4	-12.2	-12.6	-11.4	-9.4	-6.9
<i>Households and NPISHs</i>	0.1	-0.6	-1.3	-1.7	-1.6	-1.1	-0.9	-0.5	0.0
Financial institutions	1.0	0.6	0.9	0.6	1.9	2.0	1.7	1.9	1.7
General government	-0.2	-0.4	1.0	2.0	2.2	1.7	0.5	-1.6	-3.8
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-8.2	-8.7	-11.4	-17.1	-18.2	-18.9	-16.3	-14.4	-10.3

SOURCE: Banco de España.

a. Financial resources that cover the gap between expanded gross capital formation (real investment plus permanent financial investment) and gross saving.

gross operating profit fell by almost 6% in 2008 in comparison with a year earlier, signifying a decline in rates of return at these companies. These adverse developments in earnings were also reflected in an increase in debt and debt burden ratios. As a result of all the above, the synthetic indicators of financial pressure on investment and employment rose.

The growing level of financial pressure experienced by certain private-sector segments continued to be reflected in the increase in doubtful loans ratios for households and non-financial corporations. Thus, non-financial corporations posted a doubtful loans ratio of 3.7% at end-2008, up 0.9 pp on the previous quarter, with a particularly noticeable rise in the case of housing-related sectors, while households posted a doubtful loans ratio of 3%, up 0.6 pp.

The most recent Financial Accounts data show a slight reduction in the nation's net borrowing in 2008 Q4 (9.1% of GDP in cumulative 12-month terms, in comparison with 9.6% in September), as a result of the lower deficits recorded by households and non-financial corporations which offset the smaller surplus at financial institutions and the increase in general government borrowing (see Table 6). Funds raised abroad by sectors other than the Banco de España were insufficient to cover the nation's overspending relative to revenue, with the result that, once again, the Banco de España's net external assets were negative, in cumulative annual terms, although less so than in the previous quarter.

In short, the latest data continue to point to a decline in both the demand for and supply of credit, although the pace of tightening would appear to have started to slacken. At the same time, the financial position of some private-sector segments has continued to deteriorate. The cuts seen in recent months in the cost of borrowing will tend to be reflected in lower interest payments, thus helping alleviate the financial pressure on firms and households with debt, but the weak economic growth expected will have the opposite effect.

5.2 Households

The information available for 2009 Q1, to February, shows a significant reduction in the cost of borrowing for households. Thus interest rates on consumer and other credit fell by almost 90 bp, to 7.9%, while interest rates on housing loans fell by some 150 bp, to 4.4%. The continued decline in 1-year EURIBOR in March and in April to date, together with the habitual

delay in these moves being passed through to interest rates, would indicate further reductions in the cost of credit for households during this period.

Nonetheless, the decline in interbank rates has not been fully passed through to new loans to households, meaning that spreads have widened, most notably, according to the latest Bank Lending Surveys, in higher risk transactions. In this respect, the latest figures show that, in recent months, the spreads between bank lending rates and the reference interbank rate widened further in consumer loans, which present higher default rates, than in housing loans. Thus, since the end of 2008, the housing loan spread, which had been stable in previous quarters, widened by 0.7 pp, while the consumer loan spread, which had already widened in the second half of 2008 (by 1.7 pp), rose by 0.4 pp. Similarly, according to the April BLS, credit standards tightened in 2009 Q1, although significantly less so than in the second half of 2008. The banks surveyed also pointed to a further decrease in demand, albeit more moderate than in the previous period, and envisaged that the supply of credit would tighten again somewhat in 2009 Q2.

Tightening credit standards and lower demand for loans have meant that the rate of growth of household debt has continued to moderate. Thus the year-on-year growth rate declined again to 3% in February, almost 1.5 pp less than at end-2008, reflecting the lower growth both in housing loans (which rose by around 3% year-on-year) and in consumer and other lending (which rose by 2% in the last 12 months). The seasonally-adjusted quarter-on-quarter growth rates reflect a lower momentum in annualised terms and, in the case of consumer loans, point to a negative rate of growth (below -2% in February) since the end of 2008.

The latest Financial Accounts data, for 2008 Q4, show that households' acquisition of financial assets fell again in this period, to 2.7% of GDP in cumulative 12-month terms, 1 pp below the September figure (see Table 7). This decrease was due to the lower contributions to term deposits (which nevertheless remained high at 6% of GDP), to shares and other equity and to mutual funds (which again recorded net redemptions). At the same time, holdings of cash and cash equivalents rose, although the cumulative annual flow remained negative (-0.5% of GDP, in comparison with -1.5% in September).

As a result of the moderate increase in household debt, the sector's debt ratio declined somewhat in 2008 Q4, to around 125% of GDI. However, interest payments rose slightly, in cumulative annual terms, as the average cost of on-balance-sheet liabilities remained higher than a year earlier, meaning that the debt burden remained at around 18% of GDI. Despite the climb in interest payments, gross saving rose significantly, as did saving not allocated to debt servicing, to stand at approximately 2% of GDI. Lastly, household net wealth relative to income continued to decline, due to the drop in value of both its components (property and financial assets). The latest advance data indicate that these trends will continue in the opening months of 2009.

The rise in the household debt burden and the unemployment rate led to an increase in the proportion of households with debt repayment difficulties; this increase was especially significant in the case of consumer and other loans, whose default rate rose to 5.2% in December, up 0.9 pp on the September figure, while in the case of housing loans the default rate rose by 0.5 pp to 2.4%.

5.3 Non-financial corporations

The latest data on interest rates on new bank loans, corresponding to February, show a decline in comparison with December, more notable in loans over €1 million (152 bp) than in smaller loans (116 bp). The cost of issuance of short- and long-term securities also declined

FINANCIAL TRANSACTIONS OF HOUSEHOLDS, NPISHs AND NON-FINANCIAL CORPORATIONS
Four-quarter data

TABLE 7

% of GDP	2005	2006	2007	2008		
				Q2	Q3	Q4
HOUSEHOLDS AND NPISHs:						
Financial transactions (assets)	10.4	10.9	7.5	5.4	3.8	2.7
Cash and cash equivalents	4.0	3.1	-1.0	-1.6	-1.5	-0.5
Other deposits and fixed-income securities (a)	1.6	5.8	7.8	8.3	7.9	7.0
Shares and other equity (b)	0.2	-1.0	0.7	0.9	0.4	0.0
Mutual funds	1.9	0.2	-1.2	-2.8	-3.5	-3.7
Insurance technical reserves	2.0	1.8	0.9	0.7	0.7	0.5
<i>Of which:</i>						
Life assurance	0.7	0.6	0.2	0.1	0.1	-0.1
Retirement	1.0	0.9	0.6	0.4	0.4	0.5
Other	0.6	1.1	0.3	-0.1	-0.3	-0.5
Financial transactions (liabilities)	11.7	12.6	9.2	6.2	4.3	2.7
Credit from resident financial institutions (c)	12.3	13.0	9.4	6.6	5.1	3.4
House purchase credit (c)	10.2	9.9	7.0	4.6	3.7	2.7
Consumer and other credit (c)	2.2	3.1	2.2	1.8	1.4	0.8
Other	-0.6	-0.4	-0.2	-0.4	-0.8	-0.6
NON-FINANCIAL CORPORATIONS:						
Financial transactions (assets)	18.1	22.6	12.8	6.6	5.4	3.6
Cash and cash equivalents	2.0	2.3	-0.4	-1.1	-0.6	-1.1
Other deposits and fixed-income securities (a)	1.2	1.6	2.4	2.7	2.1	2.2
Shares and other equity	7.3	10.9	6.7	2.3	2.1	2.3
<i>Of which:</i>						
Vis-à-vis the rest of the world	3.9	7.7	5.5	3.5	4.0	2.9
Other	7.6	7.8	4.1	2.8	1.8	0.1
Financial transactions (liabilities)	25.2	32.0	25.0	18.1	14.8	10.5
Credit from resident financial institutions (c)	12.9	17.6	13.9	9.3	7.1	5.5
Foreign loans	2.1	3.3	2.8	2.4	2.9	2.2
Fixed-income securities (d)	0.3	1.8	0.5	0.5	0.1	0.3
Shares and other equity	3.7	2.5	5.0	4.4	3.6	2.3
Other	6.2	6.7	2.8	1.5	1.1	0.2
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	21.2	24.2	15.5	10.3	8.3	6.1
Households and NPISHs	20.9	19.6	12.5	8.4	6.5	4.4
Non-financial corporations	21.4	27.9	17.7	11.7	9.6	7.3

SOURCE: Banco de España.

- a. Not including unpaid accrued interest, which is included under "other".
- b. Excluding mutual funds.
- c. Including off-balance-sheet securitised loans.
- d. Including issues of resident financial subsidiaries.
- e. Defined as the sum of bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation special purpose entities.

in 2009 Q1 (by 183 bp and 172 bp, respectively), as did the cost of share issuance (by 13 bp).

In recent months, as in the case of households, bank rates on new loans to corporations declined by less than the reference interbank rate, as the credit institutions applied wider spreads. Since September 2008, these spreads have widened by 1.4 pp in smaller loans, but by only 0.5 pp in larger loans, possibly signalling greater contraction in lending to SMEs in comparison with large corporations, in line with the higher risk profile of these transactions. These increases

are consistent with the BLS figures which indicate that in recent months the credit institutions have tightened their credit supply via higher spreads.

Moreover, according to the April BLS, credit standards tightened again for corporations in 2009 Q1, although significantly less so than in previous quarters. This tightening, which the credit institutions expect to continue throughout Q2, is estimated to have affected all companies alike, irrespective of size, but to have been felt most in longer-term loans. The intermediaries surveyed indicated that in this period the demand for loans from corporations also fell, chiefly as a result of the decline in fixed capital investment.

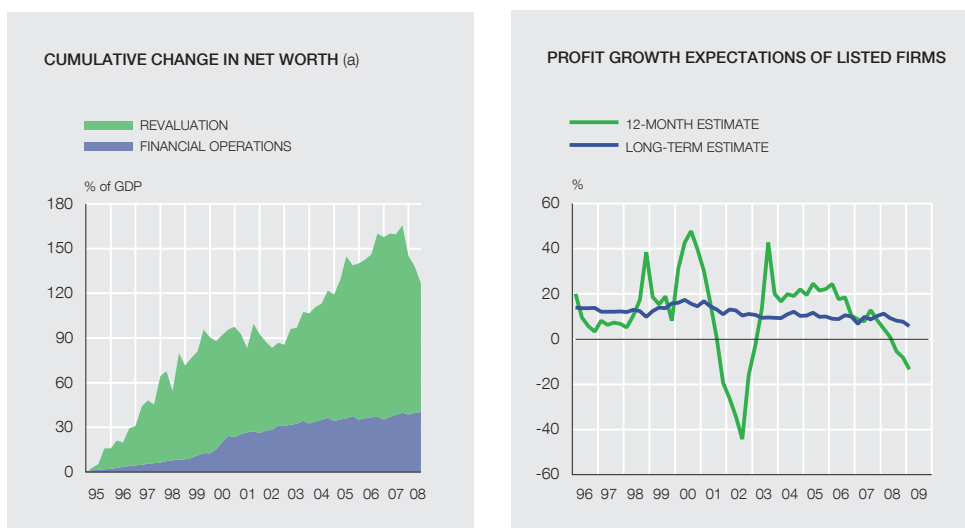
According to the business confidence index compiled by the Chambers of Commerce, the percentage of firms stating that they had difficulties obtaining credit as a factor limiting their activity rose in the second half of 2008 to over 20%; firms with between 10 and 250 employees and construction sector firms indicate the most difficulties in this respect.

In light of this tightening of credit supply and lower demand, corporate borrowing continued to lose momentum, growing by less than 7% year-on-year in February, a drop of slightly more than 0.5 pp from December. The seasonally-adjusted quarter-on-quarter and annualised rates were lower and have remained stable in recent months. The breakdown by instrument shows that this was chiefly due to a moderation in credit from resident institutions, which is the component with the most weight. By contrast, fixed-income securities, which represent a much lower percentage of total borrowing, accelerated.

The latest information on the credit breakdown by productive activity, corresponding to the end of 2008, shows deceleration across all branches of activity, but most particularly in construction and real estate services. In fact in construction the rate of growth turned negative (-1%), down 5 pp in comparison with the previous quarter. In real estate services the rate of growth was in the order of 5%, while in industry and other services it remained high, albeit somewhat below the September figures, at 10% and 14%, respectively.

In line with the slowdown in corporate liabilities, the sector's borrowing decreased in 2008 Q4, according to the latest Financial Accounts data, to approximately 7% of GDP, 2.5 pp below the September figure. The financing gap – the indicator that approximates the funds required to bridge the difference between gross corporate saving and gross capital formation plus permanent foreign investment – recorded a much steeper decline (4.1 pp), to just over 10% of GDP, in keeping with the lower momentum of Spain's direct investment in the rest of the world.

As a result of these liabilities and income developments, in 2008 Q4 the corporate debt-to-earnings ratio fell slightly in comparison with September. This, together with the increase in the average cost of on-balance-sheet funds, led to a further rise in interest payments, to approximately 28% of gross operating profit plus financial revenue. Rates of return seem to have remained similar to September levels, assisted by good corporate earnings figures on National Accounts estimates. Nevertheless, other data sources point to a less dynamic profit performance. Thus CBQ data, based on a sample in which large corporations predominate, show that gross operating profit fell by almost 6% in 2008 in comparison with a year earlier. An analysis of the activities with most representation in the CBQ, which includes neither construction nor property development, shows a particularly notable decline in industry (-24%). As a result of all the above, ordinary return on equity (ROE) diminished. Moreover, the percentage of firms with negative ordinary ROE rose by 5 pp in comparison with the previous year. In this setting, analysts once again revised down earnings growth



SOURCES: I/B/E/S and Banco de España.

a. Net worth is proxied by the valuation at market price of shares and other equity issued by non-financial corporations.

expectations for listed non-financial corporations for the next 12 months, which remain negative. The longer-term outlook has also deteriorated, although to a lesser extent (see Chart 26).

The debt and financial burden ratios of the sample of companies reporting to the CBQ rose, affected in part by the adverse income developments. The percentage of firms whose financial burdens have crossed the point at which, in accordance with the available estimates, this ratio starts to become a limiting factor on investment (see Box 6) also rose. Moreover, as a result of the combination of debt, financial burden and profit developments in the sector, the synthetic indicators of financial pressure on investment and employment based on CBQ data also rose, most particularly in the case of industry.

As the financial position of the most vulnerable companies worsened, as reflected in the CBQ and as is illustrated in more detail in Box 6, the sector's default ratio continued to rise towards the end of 2008, most notably in real estate services and construction which posted default ratios of 4.6% and 3.5%, respectively. However, in all other activities the default ratio was lower (1.9%).

5.4 General government

General government net borrowing rose significantly in 2008 Q4, up to 3.8% of GDP in cumulative four-quarter terms, 2.2 pp higher than in September (see Table 6 and Chart 27). The breakdown by instrument shows that the deficit was covered by issuing short-term, and especially medium- and long-term, securities, and by reducing the balance of deposits net of lending. Despite the recent increase in debt, the decrease in the average cost of funds held interest payments steady as a proportion of GDP at 1.6%.

5.5 The rest of the world

During the last three months of 2008, the debit balance of the nation's net financial transactions fell, in cumulative 12-month terms, to 9.1% of GDP (in comparison with 9.6% in September). By sector, this was due to lower borrowing by households and non-financial corporations, which offset the lower surplus at financial institutions and the larger general government deficit (see Table 6).

A firm's financial position conditions its hiring and spending decisions. Furthermore, there is evidence to suggest that the relationship between these two variables may be non-linear.¹ That is, a firm's financial position may have a more pronounced impact on the decision to undertake investment projects or to hire workers once a certain critical threshold has been crossed. For this reason, aggregate indicators offer a partial view of the degree of the system's financial soundness, as this may depend more on the position of the more vulnerable firms than on the corporate sector average. Accordingly, a disaggregated analysis of the financial position of the corporate sector is key to pro-

viding a correct assessment both of the macroeconomic outlook and the risks to financial stability.

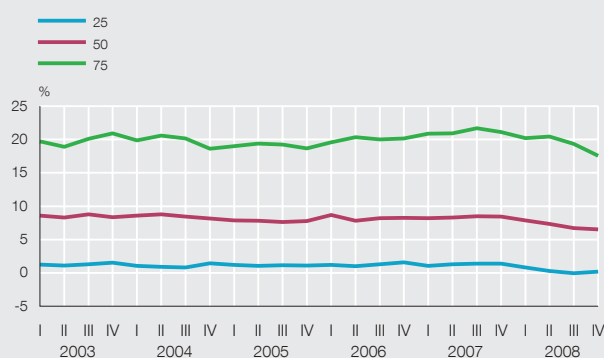
To assess recent developments in the financial position of Spanish firms, this Box analyses the distribution of different financial indicators, using the individual data of the companies included in the quarterly database of the Banco de España's Central Balance Sheet Data Office for the period 2003-2008.

As Panel 1 shows, firms' return on equity was very stable in the period analysed. The panel also shows how the deterioration in the macroeconomic situation led to a general decline in corporate profits over the last year, throughout the cross-sectional distribution of the sample analysed. If anything, the decline is slightly more notable in the high percentiles, that is, among the most profitable firms.

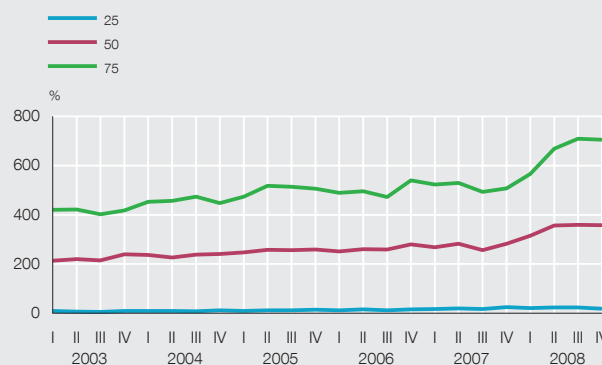
1. See I. Hernando and C. Martínez-Carrascal (2008), "The impact of financial variables on firms' real decisions: evidence from Spanish firm-level data", *Journal of Macroeconomics*, 30 (1), pp. 543-561.

DISTRIBUTION OF THE FINANCIAL POSITION OF NON-FINANCIAL CORPORATIONS REPORTING TO THE CBQ

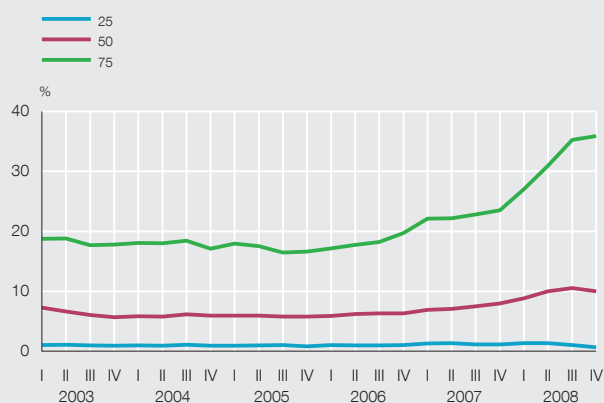
1 DISTRIBUTION OF RETURN ON EQUITY (a)



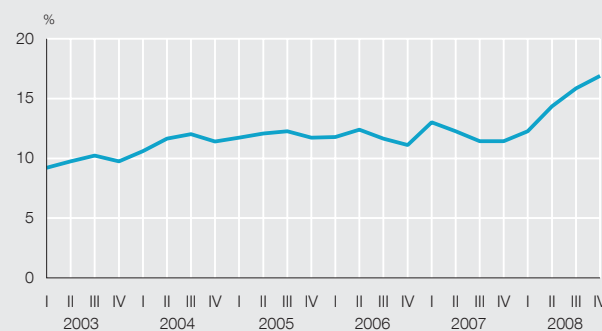
2 DISTRIBUTION OF DEBT RATIO (a) (b)



3 DISTRIBUTION OF DEBT BURDEN RATIO (a) (c)



4 PERCENTAGE OF FIRMS WITH HIGH DEBT BURDEN (d)



SOURCE: Banco de España.

a. The charts show the trends in different percentiles of the distribution of profit, debt and debt burden ratios for the sample corporations reporting to the CBQ.

b. Defined as the ratio between debt and the sum of gross operating profit and financial revenue.

c. Defined as the ratio between interest payments and the sum of gross operating profit and financial revenue.

d. Includes all firms whose ratio of interest plus short-term debt over gross operating profit plus financial revenue exceeds the 90th percentile of the distribution of this variable for the companies reporting to the CBA in the period 1985-2001.

The debt ratio, defined as the ratio between interest-bearing debt and the sum of gross operating profit and financial revenue, has risen in all the percentiles of the distribution, most notably in the last part of 2007 and in the first half of 2008 and in the higher bands of the distribution (see Panel 2). This is due in part to a slightly higher increase in debt at the most indebted firms, but above all to the widespread decline in profits which, all other factors being equal, tends to have a greater impact on debt ratios at firms with a higher relative volume of borrowing.

In the last part of the sample period analysed, the increase in the average cost of corporate liabilities helped raise the debt-burden ratio, measured as the ratio of interest payments to the sum of gross economic profit and financial revenue. As Panel 3 shows, the increase was most notable in the upper tail of the distribution, as higher interest rates and lower corporate profits have most impact on this ratio at firms that have most recourse to borrowing. Thus, for example, whilst the debt burden of the median firm rose by 2 pp in 2008, the increase was much higher (more than 12 pp) for firms in the 75th percentile.

These developments have led to a substantial increase in the percentage of firms with a higher debt burden,² up from 11% at the close of 2007 to 17% in 2008 Q4, but without reaching the levels over 20% seen in the previous downturn (see Panel 4). This rise in the share of firms that are facing greater difficulties, a priori, obtaining new loans, and whose spending decisions may, therefore, be more constrained, may affect the investment recovery. Sánchez et al (2008)³ present the results of the re-estimation of the private productive investment equation of the Banco de España's Quarterly Model (MTBE) and find evidence that this variable, which approximates the degree of financial

2. Firms are considered to have a high debt burden when this figure exceeds the level recorded for the 90th percentile in the distribution of this variable for the firms included in the Central Balance Sheet Data Office (CBSO) Annual Survey in the period 1985-2001. 3. C. Sánchez, P. Sánchez and A. Urtasun (2008), "La inversión empresarial en España y la posición financiera de las empresas", *Boletín Económico*, December, Banco de España.

pressure borne by the corporate sector, exerts an adverse influence on gross capital formation.

This increase in the percentage of firms with a high debt burden has been consistent with the recent rise in the synthetic indicators of financial pressure on employment and investment which sum up the impact that changes in various financial variables – debt, profitability and financial burden – have on these macroeconomic aggregates. These indicators are constructed bearing in mind that, in accordance with the evidence available, spending is only constrained when the financial burden rises sufficiently so as to cross over a certain threshold (see Chart 25 in the main body of the text).

To sum up, analysis of the disaggregated data in the CBQ suggests that the deterioration in the economic situation, which has started to show through in a contraction of firms' profits, together with the rising cost of borrowing led, throughout 2008, to a more pronounced increase in financial pressure at firms that had a less favourable starting point than the median or than that reflected in the aggregate indicators. Accordingly, the proportion of firms bearing higher financial pressure, and therefore whose capacity to take on new investment projects may be limited, has increased.

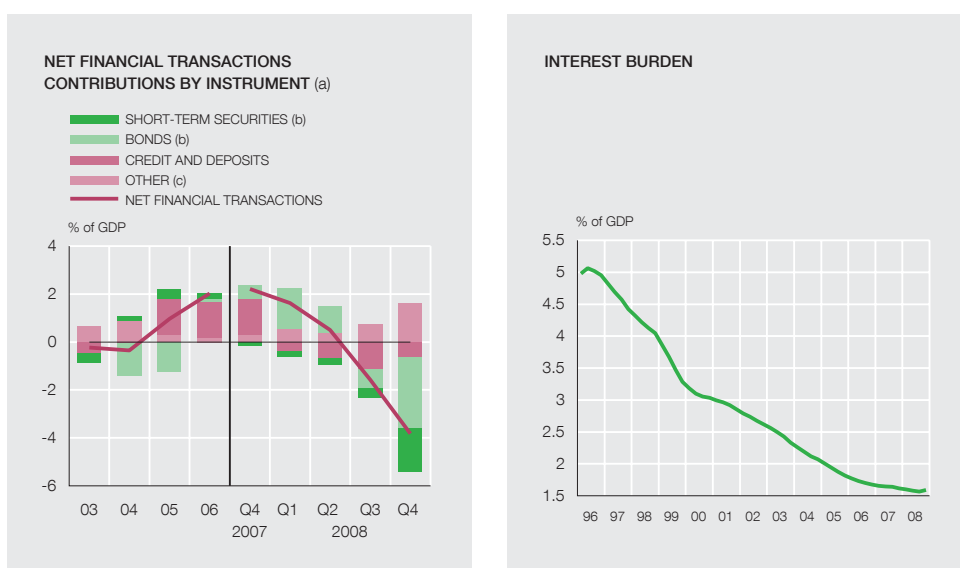
In coming months, how firms' financial positions develop will depend on two opposing factors. On the one hand, analysts' expectations point to a notable reduction in the rate of growth of corporate earnings in the short term, in step with the downturn, which would tend to increase the proportion of firms having to face growing financial pressure and which may, therefore, postpone their spending decisions. On the other, the recent decline in interbank rates will foreseeably continue to pass through to the average cost of corporate lending, given the predominance of short-term or floating-rate loans,⁴ thus helping alleviate the debt burden.

4. Thus, for example, in December 2008, 93% of the stock of loans to non-financial corporations corresponded to transactions with an initial rate fixation of less than one year.

The breakdown of financial transactions vis-à-vis the rest of the world by sector shows that, in cumulative four-quarter terms, in the closing months of 2008 the net capital inflows channelled through the financial system (excluding the Banco de España and institutional investors), which were largely interbank deposits, continued to decline as a proportion of GDP. By contrast, the volume of funds raised by general government rose, against a backdrop of larger public debt issues. Institutional investors, which continued to unwind positions in the rest of the world, also recorded positive net flows, as did the non-financial private sector, although in both cases these were somewhat lower than in 2008 Q3. But these funds were insufficient to cover the nation's overspending relative to revenue, meaning that the Banco de España's net assets vis-à-vis the external sector fell again (in cumulative 12-month terms, the net flows stood at 2.7% of GDP, in comparison with 3% in September; see Chart 28).

GENERAL GOVERNMENT
Four-quarter data

CHART 27

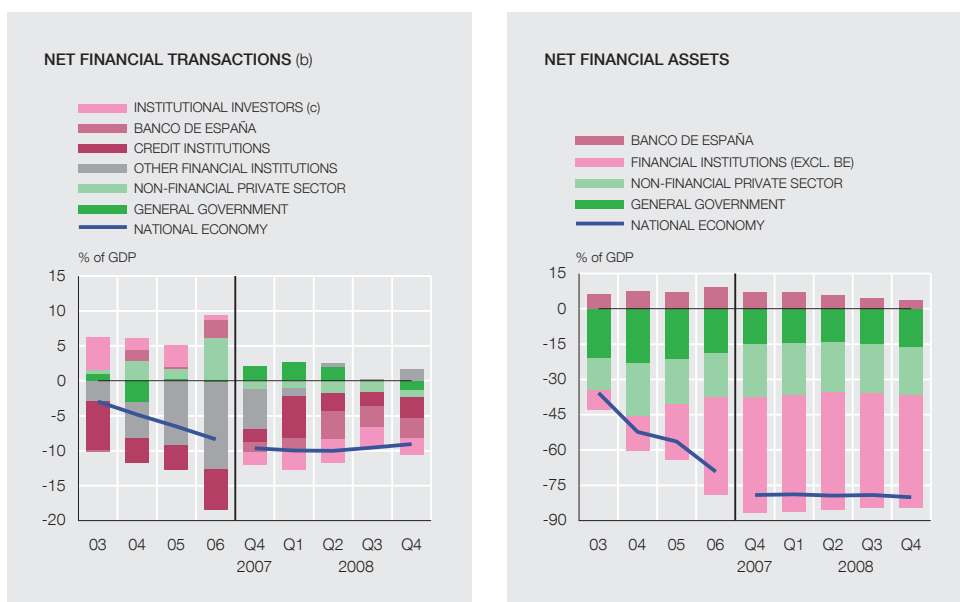


SOURCE: Banco de España.

- a. A positive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilities.
- b. Includes only liabilities transactions.
- c. Unpaid accrued interest on bonds and net investment of Social Security funds in assets issued by the rest of general government.

NET FINANCIAL TRANSACTIONS AND NET FINANCIAL ASSETS VIS-À-VIS THE REST OF THE WORLD (a)

CHART 28



SOURCE: Banco de España.

- a. Four-quarter data for transactions. End-period data for stocks. Unsectorised assets and liabilities not included.
- b. A negative (positive) sign denotes that the rest of the world grants (receives) financing to (from) the counterpart sector.
- c. Insurance companies and portfolio investment institutions.

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 8

% of GDP	2005	2006	2007	2008		
				Q2	Q3	Q4
NET FINANCIAL TRANSACTIONS	-6.5	-8.4	-9.7	-10.0	-9.6	-9.1
FINANCIAL TRANSACTIONS (ASSETS)	18.5	17.7	13.5	7.1	7.5	3.1
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	2.2	5.2	2.1	1.6	1.3	-0.3
<i>Of which:</i>						
<i>Interbank (a)</i>	3.1	3.4	4.2	4.6	2.1	-0.5
Securities other than shares	8.7	-1.2	1.6	0.9	0.9	1.1
<i>Of which:</i>						
<i>Credit institutions</i>	6.6	-2.1	1.8	1.7	1.6	1.4
<i>Institutional investors (b)</i>	2.3	0.6	-0.1	-0.5	-0.6	-0.4
Shares and other equity	5.1	10.2	7.8	3.2	3.6	1.6
<i>Of which:</i>						
<i>Non-financial corporations</i>	3.9	7.7	5.5	3.5	4.0	2.9
<i>Institutional investors (b)</i>	0.9	1.2	-1.0	-2.6	-2.1	-1.5
Loans	1.1	2.1	1.2	1.8	1.7	0.8
FINANCIAL TRANSACTIONS (LIABILITIES)	25.0	26.1	23.1	17.1	17.0	12.2
Deposits	5.6	0.3	7.3	13.0	11.3	8.9
<i>Of which:</i>						
<i>Interbank (a)</i>	7.2	0.6	6.7	10.7	8.6	6.2
Securities other than shares	15.8	21.7	7.9	-3.4	-1.6	-2.4
<i>Of which:</i>						
<i>General government</i>	0.2	1.3	-1.6	-1.9	0.1	1.4
<i>Credit institutions</i>	6.3	8.0	3.5	-1.1	-1.6	-2.2
<i>Other non-monetary financial institutions</i>	9.3	12.4	5.9	-0.4	-0.2	-1.6
Shares and other equity	0.9	-0.1	4.3	4.8	4.5	3.6
<i>Of which:</i>						
<i>Non-financial corporations</i>	1.0	-0.5	4.5	4.4	4.0	2.7
Loans	2.3	3.5	3.1	2.4	2.8	2.1
Other, net (c)	-0.9	-0.8	-0.2	0.6	0.2	0.1
MEMORANDUM ITEMS						
Spanish direct investment abroad	3.7	8.5	9.6	8.1	7.7	4.8
Foreign direct investment in Spain	2.2	2.5	4.8	6.7	7.0	4.1

SOURCE: Banco de España.

- a. Correspond only to credit institutions and including repos.
b. Insurance corporations and collective investment institutions.
c. Including, in addition to other items, the asset-side caption reflecting insurance technical reserves and the net flow of trade credit.

The volume of capital inflows declined in the closing months of 2008 to slightly more than 12% of GDP in December, almost 5 pp down on September in cumulative four-quarter terms (see Table 8). This decrease affected all instruments, but especially investment in shares and other equity and deposits (particularly interbank deposits), although in net terms the funds received through this channel rose in comparison with the previous quarter. The net financing obtained from securities other than shares continued to post a negative balance, in excess of that recorded three months earlier (2.4% of GDP in comparison with 1.6%), and this despite the higher volume of funds obtained through general government securities. Relative to GDP, foreign direct investment in Spain declined by almost 3 pp to 4.1%.

Capital outflows in 2008 Q4 also declined, to slightly more than 3% of GDP in cumulative annual terms, more than 4 pp below the September figure (see Table 8). By instrument, acquisitions of shares and other equity by resident agents fell, as did Spanish direct investment abroad (down by almost 3 pp relative to GDP to just under 5%), in keeping with the above-mentioned decrease and the decline in related company financing. By contrast, investment in fixed-income securities in the rest of the world rose slightly.

As a result of cross-border financial flows and changes in asset prices and in the exchange rate, the Spanish economy's accumulated net debt vis-à-vis the rest of the world rose marginally above 80% of GDP, 1 pp higher than in September (see Chart 28). By sector, this was essentially the result of the increase in general government and non-financial private sector debt vis-à-vis non-residents and of the reduction in the credit balance of the Banco de España which was higher than the decrease in the debt balance of other financial institutions.

24.4.2009.